

# RESTRAINING LEVIATHAN

The book cover features a stylized illustration of a large, classical-style building with a central portico and columns. The building is supported by four thick, metallic-looking legs that extend upwards and outwards, meeting at a central point where a flagpole is located. The flagpole holds the New Zealand flag. The background is a blue sky with white clouds. The title 'RESTRAINING LEVIATHAN' is written in large, bold, black letters at the top, and the subtitle 'Small Government in Practice' is written in a smaller font below it, enclosed in a cloud-like shape.

Small Government in Practice

Edited by  
Michael James

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THE CENTRE FOR INDEPENDENT STUDIES

# **Restraining Leviathan** **Small Government in Practice**

CIS POLICY FORUMS 6

# **Restraining Leviathan**

## **Small Government in Practice**

**edited by**  
**Michael James**

The proceedings of a Conference organised by the  
Centre for Independent Studies, held in Sydney on  
17-18 November 1986



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# Table of Contents

Foreword	
<b>David Band</b> .....	ix
Editorial Note.....	xi

## INTRODUCTION

Reassessing the Scope and the Limits of Government	
<b>Michael James</b> .....	1

## THE AUSTRALIAN EXPERIENCE OF BIG GOVERNMENT

Measuring the Size and Growth of the Public Sector in Australia	
<b>Peter Saunders</b> .....	9
'A Vast Public Utility': The State in Australians' Experience and Expectations	
<b>Hugh Collins</b> .....	47
Comments	
<b>J.J. Pincus</b> .....	58
Discussion.....	64

## ELIMINATING WASTE IN PUBLIC EXPENDITURE

Achieving Public Objectives with Less Money	
<b>Patrick Minford</b> .....	67
Reducing Public Sector Spending in Australia: Strategies and Options	
<b>Cliff Walsh</b> .....	97
Comments	
<b>Peter Swan</b> .....	127
Discussion.....	130

## DEREGULATION

Business Regulation — Its Scope, Costs and Benefits in Australia <b>A.J. Moran</b> .....	133
The Political Economy of Deregulation <b>Ian R. Harper</b> .....	157
Comments <b>Wolfgang Kasper</b> .....	173
Discussion.....	177

## PRIVATISATION

'Privatisation' — A Relevant Word for Australia? <b>Chris Trengove</b> .....	179
Privatisation: Possibilities and Prospects in the Transport Sector <b>Keith Trace</b> .....	201
Comments <b>Peter Forsyth</b> .....	230
Discussion.....	232

## CONTROLLING PUBLIC EXPENDITURE

Macro Controls on Public Spending <b>Jon D. Craig</b> .....	235
Policy Termination and Innovation: Making Leviathan Agile <b>Scott Prasser</b> .....	259
Comments <b>James Cox</b> .....	277
Discussion.....	282

**CONSTITUTIONAL CONSTRAINTS ON  
GOVERNMENT SIZE**

The Death of Constitutional Law — 'Paper Tigers' and Utilitarian Government <b>Robin O'Hair</b> .....	285
Constitutional Routes to Smaller Government <b>Geoffrey Brennan</b> .....	309
Comments <b>George Winterton</b> .....	331
Discussion.....	334

**SUMMARY**

Concluding Discussion led by <b>Geoffrey Brennan</b> .....	339
Index .....	345

# Foreword

David Band

*Good, and Evil, are names that signifie our Appetites, and Aversions; which in different tempers, customes, and doctrines of men, are different: And divers men, differ not onely in their Judgement, on the sense of what is pleasant, and unpleasant to the tast, smell, hearing, touch, and sight; but also of what is conformable, or disagreeable to Reason, in the actions of common life. Nay, the same man, in divers times, differs from himselfe; and one time praiseth, that is, calleth Good, what another time he dispraiseth, and calleth Evil.*

This book, *Restraining Leviathan*, is confirmation of how far we have moved from the insights of the original *Leviathan*, how far we have strayed down the path of thinking that there is only one kind of social arrangement appropriate to our times and circumstances. But the book is evidence as well of the turning of the intellectual tide that has occurred in the liberal democracies (and beyond) over the last 15 years. Hobbes speaks of 'that which in the disputations of scholars is called *absurdity*', and in this volume our disputatious scholars leave us with the clear impression that, in our submission to the state, we have reached the point of absurdity.

Again, Hobbes advises that 'a man ... be contented with so much liberty against other men, as he would allow other men against himselfe'. It is instructive and disturbing to consider how today's citizens are encouraged to ignore this dictum, for why should I worry about my or my fellows' freedom while I am in the protective custody of the state? Indeed, one of the greatest of this book's many virtues is its highlighting of the extent to which the size of government is not a fiscal but a moral problem.

This may seem a strange conclusion to draw from a work in which statistical and procedural arguments feature so heavily. But it follows, I believe, from the firm impression with which those arguments leave the reader. Virtually every contributor provides daunting evidence (a) of the quite extraordinary degree to which the citizens of free societies have allowed (more often asked) the state to remove growing portions of their liberties; and (b) of the difficulties faced by anyone concerned to reverse this process.

Thus the message that Dr James's collection sends us is that there may well be a danger in concentrating on the scope for governments, rather than the scope for persons. It sets an agenda in reminding us that the very origins of the 'smaller government' debate lie in both efficiency and liberty arguments. The issue of the 'appropriate size of government' is a question of means, not of ends. It should have as its central point of reference the maximum practical degree of personal freedom. Dr James's reader shows us not why reducing the scope of government is so difficult, but why it is so necessary.

A key requirement now is for us to examine critically the moral foundations of government. The second item that this book places on the intellectual agenda is the analysis of the ability of government to achieve the tasks it sets itself. We need to look at the very nature of the public sector, its managerial and employment practices and its culture, and the reasons why they stand in the way of government's completing those tasks satisfactorily.

Finally, let us recall that, in the original *Leviathan*, the point and function of civil society was to remove us from the 'miserable condition' of the state of nature. Let us remember one of Hobbes's descriptions of the state of nature, and wonder how far it is from the world created by our modern Leviathan:

In such condition, there is no place for Industry; because the fruit thereof is uncertain: and consequently no Culture of the Earth.

Restraining Leviathan may well be too modest an objective.

## Editorial Note

This volume records the proceedings of a conference, organised by the Centre for Independent Studies, and held in Sydney on 17-18 November 1986, on the theme of reducing the scale of government intervention in Australia. It reproduces not only the papers read at the conference but also the remarks of the commentators; and it includes edited versions of the floor discussion that followed each session.

This editorial note provides me with an opportunity to thank Rose McGee for her help in preparing the volume, and above all for attending so expertly to the many minutiae of style and consistency that collections of this sort involve. I am grateful also to Karla Whitmore for the major part she played in organising the conference.

**Michael James**

# Reassessing the Scope and the Limits of Government

*Michael James*

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His interests include democratic theory and constitutionalism; his publications in those areas include *Parliament and the Public Interest* (1985) and a collection of readings he edited for the CIS, *The Constitutional Challenge* (1982). In 1986 he was convener of the CIS conference 'Restraining Leviathan: Small Government in Practice'. His monograph *How Much Government?* was published by the CIS in 1987. He is currently working on the moral foundations of welfare for the CIS Social Welfare Project.

# Reassessing the Scope and the Limits of Government

*Michael James*

A criticism sometimes levelled at supporters of smaller government is that whereas they call vociferously for cutbacks in the scale of state intervention, they are reluctant to specify where those cuts should be made: that they avoid coming out with the 'small government agenda'. This volume is not an attempt to meet that criticism. We shall of course be considering several classes of intervention as suitable cases for disintervention, so to speak. But the emphasis will be rather on the principles for determining where the state should and should not intervene, and the processes by which cutbacks can be secured. This approach is entirely defensible. We all of us might have our own private menus of cutbacks, but no one such menu is likely to command wide support. Conversely, we are much more likely to agree on the appropriate procedures for deciding which interventions should be retained and which should be dispensed with. Ideally, if those procedures could be agreed, then the process of cutting government down to size and keeping it there would be a purely administrative matter. And yet the question whether there might be emerging a consensus of a new agenda for government does seem worth putting; and I want to devote some of these opening remarks to considering this possibility.

We can gain some idea of just how much the climate of opinion towards intervention has changed by recalling the 'big government' agenda recommended 12 years ago by Professor James Meade, the Cambridge economist and leading advocate of the mixed economy. In his book *The Intelligent Radical's Guide to Economic Policy* (1975), Meade set out to promote efficiency and equity while avoiding large concentrations of wealth and power. This required, he said, removing unnecessary restrictions on the free market, but it also required 'a necessary superstructure of controls and interventions', whose elements he classified under eight heads. These were: the control of inflation; regulation of the monopoly power of corporations and trade unions; state ownership of natural monopolies; providing public goods like the legal system and internal security; promoting equality of opportunity and a more equal distribution of income and wealth; using indicative planning

to overcome economic uncertainty; central planning of significant structural changes in the economy; and eliminating externalities through control of the environment, of exhaustible resources, and of population growth (Meade, 1975:13-16).

Nineteen seventy-five was perhaps the last year in which it could be plausibly claimed that most "intelligent radicals" supported this activist, Keynesian agenda. Since then opinions have changed, not so much about the goals we want government to achieve but about the ability of governments to promote them through policies of the kind that Meade recommends. Experience of big government has suggested two major obstacles to policy success. The first is that politicians and public servants may not have access to the information on the basis of which to judge whether the market has failed and, if so, whether it can be remedied by government intervention. We may be disappointed by market outcomes, but it does not follow that government intervention can produce better ones. A powerful intellectual basis of this particular critique of intervention has been supplied by the revival of Austrian economics, and in particular that of Hayek. According to the Austrian economists, uncertainty and ignorance are not failings to be cured by government so that some optimal equilibrium can be achieved; rather, they are enduring facts of economic life, and it is the special task of the market to deal with them. Since economic information is necessarily decentralised among millions of actors and disclosed in millions of market transactions, government intervention is more likely to block than to facilitate the flow of such information via the price mechanism. This line of reasoning need not rule out all interventions, especially those designed to promote goals other than efficiency. But it does make us aware that intervention is likely to incur not only unintended and unforeseeable costs, but even undetectable ones, thus making it difficult for us to make rational judgments about particular interventions.

The second major obstacle to policy success is that the official purposes of intervention may be frustrated by the rational actions of the individuals who are affected by it. The problem is not so much that politicians, public servants, interest groups and voters are motivated by self-interest, since there is no reason to expect individuals to behave more altruistically as political actors than as economic ones. The weakness is procedural, in that political processes may contain no "invisible hand" that reconciles individual self-interest with the public good. Our understanding of how individuals interact politically has been greatly enhanced in recent years by public choice theory. Mancur Olson has shown that organised special interest groups can usually maximise their collective benefits by imposing restrictive practices that inflict great cumulative harm on the general public. The Virginia School theorists James Buchanan and Gordon Tullock have shown how easy it is for special interests to capture the processes of democratic politics and

to turn them into instruments of depredation. So even where there is a consensus on an agenda of intervention, government may fail to implement it if political processes are not shaped by an appropriate constitutional framework.

These theoretical explorations of the natural limits of government and of the of biases and imbalances of democratic processes have rendered us highly alert to the possibility that interventions may fail. They also raise the prospect that a new, post-collectivist consensus is forming around a 'limited government' agenda of the kind advocated by the classical liberal thinkers. The agenda Milton Friedman has been elaborating over the last 25 years is perhaps the most likely candidate for such a role. It is a near-complete agenda; Friedman has made policy recommendations in virtually every area of intervention. In addition, Friedman's agenda is intellectually appealing because it is derived rigorously from a small set of premises. His basic commitment to individual freedom allows intervention on only three grounds: to supply clear public goods such as the legal system and defence; to rectify market imperfections arising from natural monopolies and externalities; and to protect children and other individuals who cannot be held responsible for their actions.

Yet this line of reasoning does not entirely rule out the welfare state. Friedman treats state funding of basic education and of action to alleviate poverty as compensation for certain externalities. An individual's education, he says, benefits the public as a whole in helping to maintain a stable and democratic society. Private charity likewise benefits not only the recipients but also those who would otherwise be distressed at the sight of poverty. Since individual initiative is therefore unlikely to provide sufficient resources to these purposes, the state may legitimately step in to make up the deficiency. A similar case could no doubt be made for state involvement in health care (Friedman, 1962).

Nevertheless, I see no immediate prospect of Friedman's version of the limited state becoming the basis of a new political consensus, not so much because Friedman's justification of the minimal welfare state is faulty, but because I doubt whether many of the people who concern themselves with the subject justify in that way. Many people support a comprehensive and universal welfare system because they believe it promotes social justice and fraternity. John Rawls's theory of social justice, which stipulates that social and economic inequalities are unjustified unless they are to the greatest benefit of the most disadvantaged groups in society, has been especially influential. This version of moderate egalitarianism is much closer to Meade's agenda, which prescribes the deliberate reduction of the highest incomes, than to Friedman's, which provides a guaranteed minimum income but does not pursue equality for its own sake.

So I see every prospect of disagreement persisting about the purposes and the functions of the welfare state. Of course, supporters of extensive welfare provision have every reason to be aware of the likely causes of policy failure. Since welfare must be financed by economic growth, they need to know the limits of the state's ability to promote such growth through direct intervention. Likewise, they can scarcely afford to be ignorant of the ways in which desired patterns of distribution may be upset by political processes. The incremental growth of the welfare state over many decades has resulted in a very great deal of 'churning', which keeps many public servants occupied in returning tax revenue into the pockets of those who have paid it rather than those who might need it. Anyone concerned about the plight of the worst-off must take seriously the emerging evidence that high marginal tax rates reduce the amount of tax paid by the highest-income earners, and that lower tax rates could make it possible to remove the worst-off from the income tax net altogether. These considerations might lead to some agreement on the need to reform the way that welfare is administered. But the vital questions of the amount of welfare that should be dispensed, and the maximum degree of inequality that should be tolerated, are likely to be settled, re-opened and settled again by ordinary political means for a long time to come.

Finally, I want to respond to two objections that are sometimes expressed by those who would otherwise be convinced of the likely benefits of smaller government. The first objection is that those benefits could easily be offset by corresponding increases in the power of big business and big unions. It may be true that James Meade's agenda fails to achieve the goal of avoiding 'large concentrations of power which threaten personal independence', since it turns the state into just such a concentration. But could it be that the space left by a contracting state would be filled easily by other, possibly no less dangerous monopolies? That this misgiving sounds so reasonable is a measure of one of the most damaging intellectual effects of big government: the obliteration of the distinction between state and law. The arbitrary, unconstrained interventions of ubiquitous governments, however technically 'legal', have done much to erode our understanding of law as a body of general and impartial rules that impose no particular purposes on individuals but protect them from coercion, and compensate them for damages, arising from any quarter. Any reduction in the scale of state intervention is likely to be followed by a demand for the clarification of individual rights and for improved access to legal remedies. Whether or not this can be best supplied by constitutional reform is an open question. But a particularly important legal aspect of the case for smaller government is that many of the market imperfections currently used to justify intervention could be remedied by the appropriate clarification and extension of individual property rights.

The second objection to the case for smaller government is that the failure of such committed small-government politicians as Ronald Reagan and Margaret Thatcher even to halt the steady annual increases in public spending has shown the futility of trying to resist the forces making for government growth. It is certainly the case that most of the current explanations of government growth argue that it is an unintended phenomenon, the accidental by-product of established commitments and processes that remain impervious to ideological change. The public choice explanation, which, as already noted, stresses the role of special interests, seems to lead us into a prisoner's dilemma. Even if we all believed that smaller government would be in our best interests, individually and collectively, it would still be irrational for anyone to let go of his current benefits, so long as he has reason to expect his fellow citizens to take advantage of any such sacrifice rather than follow his example. But if we are so well and truly locked into the status quo by our vested interests, how is exploring techniques for making government smaller going to supply the bridge on which we can get from here to there?

Yet the evidence does not entirely bear out such pessimism. Indeed, Gordon Tullock (1986:13-27), one of the founders of public choice, has observed that, contrary to the impression given in some of the literature, government has not been growing at all times and in all places. This is even true of democratic governments: In America, the government's share of GNP was the same at the end of the 19th century as it had been at the beginning. In modern Switzerland, that share has remained static and, at 30 per cent, relatively low over the last decade. But the example that most strongly suggests a causal role for ideas is that of 19th-century Britain, where the level of intervention steadily declined and then began to rise again. In 1790 public spending consumed 12 per cent of the national income; by 1890 it had declined to less than 9 per cent. Thereafter it began to increase and nowadays consumes nearly half the national income (Burton, 1985:20-1). Intellectual change preceded both phases of this cycle. In 1776 Adam Smith formulated a critique of the the protectionist, mercantilist state, a critique that became the conventional wisdom of the 19th century. By the end of the century, that wisdom was being challenged by the collectivist ideas of 'the new liberalism', which sanctioned welfarist interventions. None of this proves, of course, that the growing scepticism about the real benefits of big government will inevitably lead to major and permanent cuts in state intervention. But while we know so little about the subject, we cannot rule out the possibility that transformations in the climate of opinion are a necessary condition for fundamental changes in the relationship between society and the individual. In any case, at the present time there is little we can do other than develop the case for smaller government

and refine our ideas about how the level of state intervention can best be reduced.

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# Measuring the Size and Growth of the Public Sector in Australia

*Peter Saunders*

Measuring the Size and Growth  
of the Public Sector in Australia

Peter Saunders

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# Measuring the Size and Growth of the Public Sector in Australia

*Peter Saunders*

## I. INTRODUCTION

The theme of this conference is central to the current debate on the reasons for the decline in economic performance in the last decade. The extent to which the growth of government in the post-war period has contributed to economic decline is an important question to consider. It is receiving increasing attention in Australia and in most other industrialised countries, and appropriately so. The aim of this paper is to provide a background to this debate by detailing several aspects of the size and growth of government in Australia over the last two decades. The main emphasis is on measuring the cost of government in the budgetary sense, in terms of the resources used by governments to finance their spending programs.

This budgetary perspective on the cost of government is, of course, much narrower than the broader question of the overall economic cost of government. To address the latter question we must take account of the effects of government interventions on incentives and other aspects of economic behaviour, and how these in turn impose efficiency costs on the economy by affecting the overall pattern of resource allocation. Accompanying these broader economic costs are many economic and social benefits flowing from government interventions in the economy. Questions relating to the overall cost-benefit appraisal of government will not be addressed here, this paper concentrating on measuring the size of government rather than its economic impact.

The basic unit of government as defined by the Australian Bureau of Statistics (ABS) in its National Accounts statistics is the public sector, or all public authorities. These data distinguish between the general government, public trading enterprise and public financial enterprise sectors. In contrast, the ABS Public Finance publications are based on a sectoring that excludes public financial enterprises. The public sector is defined there to include not only the Commonwealth budget sector, State budgets and local government, but also non-budget statutory authorities at both the Commonwealth and State government levels. Furthermore,

the extensive network of transfers between each of these main elements must be consolidated to derive outlays for the public sector as a whole. These complexities imply that no single measure of the size of government is suitable for all purposes. They also imply that considerable care is required when comparing the size of government in Australia with other countries where statistical units may not correspond to those used here. The United Nations System of National Accounts (SNA) data published by the OECD, for example, on which many international comparisons of the size of government are based, uses as its basic unit the concept of general government. This is considerably narrower in scope than the public sector definition used in the Australian National Accounts, as explained further in Section IV below, where these issues are dealt with more thoroughly.

It is also important to recognise that many government interventions in the economy are not captured adequately, sometimes not at all, in outlay (or employment) statistics as recorded in budget papers or the national accounts. Furthermore, estimates of the magnitude of such interventions cannot in most cases be meaningfully aggregated with more readily available indicators of the size of government. It is thus not possible to derive a single all-encompassing measure of the size of government; rather, we must acknowledge that any comprehensive indicator will, necessarily, be multidimensional. This is not surprising given the diversity of activities and forms of intervention that have accompanied the development of governments in the post-war period. Such recognition, as Break (1982) has emphasised, brings with it two important aspects of the role of government that are worth emphasising in light of the papers presented here:

One is that there may be no single answer to whether that role is expanding or contracting. The other is that there may be no easy way to place effective limits on the rate of growth of that role. (Break, 1982:294)

To the extent that the various forms of government intervention are substitutes, trends in any single measure of government size may provide a misleading indication of government's overall growth. Similarly, constraints on any single dimension — the Trilogy, for example — may provide incentives for governments intent on expansion to seek other forms of intervention in pursuit of their objectives. Indeed, since such interventions often tend in any case to by-pass the normal processes of assessment and control faced by budget outlays, such incentives already exist. How serious a problem this is in practice is difficult to assess because data on the size of these activities are often lacking. Several recent initiatives in Australia are, however, leading to an improvement in this situation, at least for two forms of such

government activity, tax expenditures and business regulation.

The outline of this paper is as follows: Section II discusses the size and growth of public sector outlays and their breakdown by level of government. This is followed in Section III by a similar discussion of the size and growth of public sector employment. Section IV puts a broader perspective on the discussion by comparing general government outlays and employment in Australia with other OECD countries. The concept and size of tax expenditures is addressed in Section V, while Section VI briefly discusses available information on the costs to government of business regulations. The main findings are brought together and summarised in the final Section.

## II. PUBLIC SECTOR OUTLAYS

The most common measure of the size of government is obtained by expressing total outlays relative to Gross Domestic Product (GDP). The resulting outlay share is not a share in the conventional sense because the numerator includes transfer payments while the denominator excludes them and measures the total value of production only. As a result, the maximum value of the share could, in principle at least, exceed unity. The significance of this observation is reinforced by the fact that transfer payments represent the fastest growing category of public sector outlays. It is also worth noting that government outlays relate primarily to the input costs incurred in the provision of goods and services, whereas private sector contributions to GDP are expressed in terms of the value of output. Further, when GDP is valued at market prices — the usual practice — it becomes sensitive to changes in the importance of indirect taxes as a source of government revenue. For these reasons, the share of outlays in GDP does not indicate the proportion of GDP produced by government, or spent by government. It does, however, indicate the proportion of productive resources that will ultimately be required to finance the activities of government, in the form of either taxes, charges or borrowings.

There is also the point that measures of public sector outlays that extend to public trading enterprises exclude their operating outlays. Included are outlays on current and capital goods and services only. Public trading enterprise operating outlays enter the public finance accounts on the revenue side in the calculation of their net operating surplus. This treatment is consistent in the sense that it is only those outlays in excess of public trading enterprise operating surplus that will impose financing obligations on the public sector.

Estimates of the size of public sector outlays in Australia are further complicated by an extensive system of grants and transfers between different public authorities. Some of these are horizontal, reflecting

transfers between the budget and non-budget sectors at both Commonwealth and State levels. More important than these are transfers between the different levels of government, a reflection of vertical fiscal imbalance between outlays and own-source revenues at each level. As Table 1 illustrates, revenue from taxes, fees and fines financed some four-fifths of Commonwealth outlays in 1984-85, only one-quarter of State government outlays, and just below half of local government outlays. In that year, some \$19 650 million or 29.7 per cent of Commonwealth outlays took the form of grants to the State and local government sectors: 45.9 per cent of State outlays were financed directly by grants from the Commonwealth and 22.6 per cent of local government outlays were financed directly by grants from the Commonwealth and the States. As a result of such intergovernmental grants and transfers, consolidated outlays for all public authorities are well below the sum of outlays at each level within the public sector.

Table 1  
Outlays and Revenue Sources by Level of  
Government, 1984-85

	Outlays (\$m)	Revenue Sources (%)		
		Taxes, fees and fines	Other revenue	Financing transactions
Commonwealth Govt Sector	66 146	80.0	7.9	12.1
State Govts	42 635	25.7	57.9	16.4
Local Govts	5 152	48.9	43.2	7.9
All Public Authorities	89 924	73.8	9.9	16.3

Note: All figures are provisional.

Source: ABS, *Government Financial Estimates, Australia 1985-86*, Catalogue No. 5501.0.

The growth of public sector outlays over the last 15 years is summarised in Table 2 and illustrated in Charts 1 and 2. Between 1970-71 and 1985-86, total public sector outlays increased from 31.5 per cent to 43.4 per cent of GDP. Much of this increase, almost eight percentage points, took place between 1973-4 and 1977-78, although a further sharp rise occurred in 1982-83 (Chart 1). Since then outlays

Table 2  
Public Sector Outlays, Receipts and (Net) Borrowings  
(percentage of GDP)

	1970-71	1975-76	1980-81	1985-86
<b>Commonwealth Sector:</b>				
Outlays	24.7	30.4	28.0	31.7
Receipts	24.5	25.2	26.3	28.2
Net Borrowing Requirement	na	4.6	1.1	2.7
<b>State and Local Govt Sector:</b>				
Outlays	16.7	20.6	20.7	22.1
Receipts	13.7	17.9	17.3	19.8
Net Borrowing Requirement	na	0.4	2.0	2.2
<b>All Public Authorities:</b>				
Outlays	31.5	38.3	38.0	43.4
Receipts	29.9	32.2	33.6	36.8
Net Borrowing Requirement (PSBR)	na	4.9	3.1	4.9(p)

- Notes:
- na = not available; p = provisional.
  - Commonwealth budget advances to finance deficits in the State and Local Government Sector are deducted from the Commonwealth's borrowing requirement.
  - Data for 1980-81 and 1985-86 are adjusted for known sale and lease-back transactions.

Source: Budget Paper No. 1, Statement No. 6: 1986-87; 1985-86; and 1980-81.

have remained almost constant relative to GDP. Over the period as a whole, public sector outlay growth exceeded nominal GDP growth by 2.2 per cent per annum. As Chart 2 indicates, the growth in net expenditure on goods and services relative to GDP has been much lower, particularly by the Commonwealth. Together, Charts 1 and 2 point to the important role that the growth in transfer payments has played in explaining the overall rise in public sector outlays. The other notable trend shown in Table 2 is the increased importance in the last decade in

Chart 1  
Public Sector Outlays as a Percentage of GDP

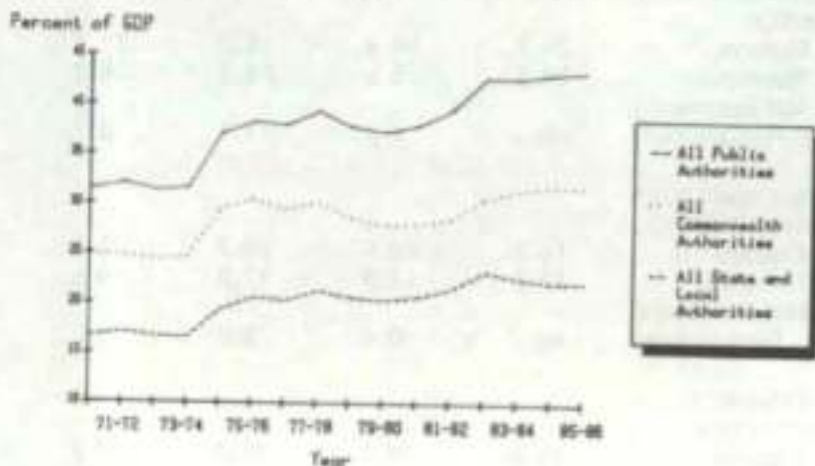
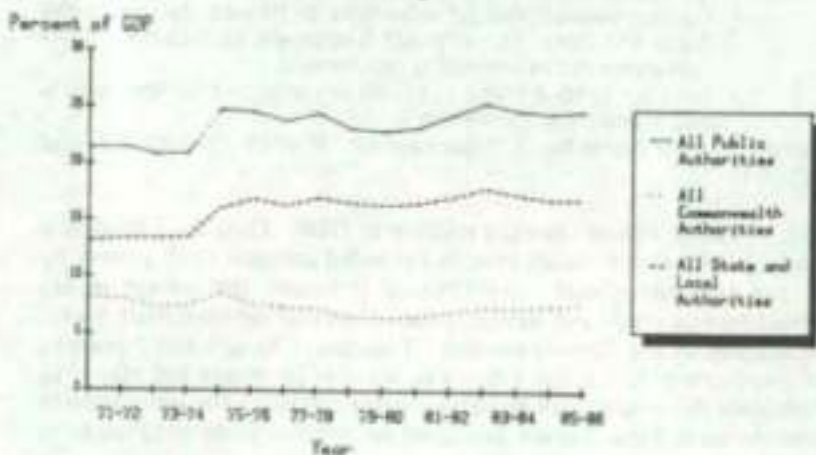


Chart 2  
Public Sector Net Expenditure on Goods and Services as a Percentage of GDP



the net borrowing requirement of State and local governments, relative to GDP and to the total public sector borrowing requirement.

It is already apparent that the growth in public sector outlays has been accompanied by important compositional changes. One element of this has been the change in the economic composition of outlays, which has in turn affected the pattern of outlays between the different levels of government because of the marked differences in outlay composition within the public sector (Table 3). Thus for example some two-thirds of Commonwealth outlays now take the form of non-interest transfer payments, while these represent a much smaller proportion of State outlays and only 3 per cent of local authority outlays. In contrast, exhaustive final consumption and capital expenditures account for less than one-quarter of Commonwealth outlays, almost three-quarters of State outlays and over four-fifths of local authority outlays.

The most notable general trend illustrated in Table 3 is the decline in capital expenditure relative to total outlays throughout the public sector. This trend is particularly marked at the Commonwealth level, where capital expenditure also declined relative to GDP. Accompanying the declining importance of capital spending has been a rise in the relative importance of current spending, again most significantly by the Commonwealth, where interest payments and personal benefit payments together rose from less than 29 per cent of outlays in 1970-71 to over 41 per cent by 1985-86.

Other aspects of the changing composition of public sector outlays have been highlighted in the work of the Office of the Economic Planning Advisory Council (Office of EPAC, 1985). Analysing trends over the last three and a half decades, this work points to significant changes in the functional composition of outlays away from the more traditional areas of collective goods (defence and general public services) and economic services (transport and communication; industry assistance and development; labour and employment), and towards the social services in the form of outlays on education, health, housing and community amenities and social security and welfare.

As noted in the EPAC paper:

the switch in emphasis of government activity, away from the provision of public goods and services, and towards a more direct influence in the household income generation process represents a significant shift in the role of government in the economy. (Office of EPAC, 1985:9)

These changes in the role of government, as opposed to its overall size, are important in the context of assessing the economic impact of government. In broad terms, they correspond to similar developments in

Table 3  
Public Sector Outlays by Economic Classification  
(percentage of outlays within each sector)

	1971-72	1975-76	1980-81	1985-86
<b>Commonwealth Authorities:</b>				
Final consumption	23.4	18.6	19.6	19.2
Capital expenditure(a)	8.7	6.8	3.7	4.1
Interest, etc.(b)	6.6	4.4	7.3	10.4
Personal benefit payments	22.1	27.3	29.8	31.0
Other(c)	39.2	42.9	39.6	35.3
<b>State Authorities:</b>				
Final consumption	42.3	52.0	51.0	1984-85 48.5
Capital expenditure(a)	35.2	31.3	25.5	25.0
Interest, etc.(b)	14.8	9.4	10.6	12.7
Personal benefit payments	2.1	1.7	1.5	1.8
Other(c)	5.6	5.6	11.4	12.0
<b>Local Authorities:</b>				
Final consumption	25.5	28.5	33.3	1984-85 35.3
Capital expenditure(a)	60.9	60.7	52.6	48.4
Interest, etc.(b)	11.8	9.3	11.6	13.3
Personal benefit payments	1.8	1.5	2.6	3.0
Other(c)				

Notes: (a) adjusted for estimated lease-back arrangements.  
(b) includes interest payments, land rent, royalties and dividends.  
(c) includes current grants, subsidies to enterprises and other current transfers.

Sources: Australian Bureau of Statistics, *Government Financial Estimates, Australia*, Catalogue No. 5501.0, and *State and Local Government Finance, Australia*, Catalogue No. 5504.0; various issues.

most other OECD countries in the post-war period, as indicated in the study by Saunders and Klau (1985). In the broader context of the economic impact of the growth of government, such compositional changes are probably of greater significance than the growth in government itself.

Mention has already been made of the importance of the non-budget sectors at both Commonwealth and State government levels. Commonwealth non-budget authorities include such public trading enterprises as Telecom, Australia Post, Qantas, Australian Airlines and the Australian National Railways. The State non-budget sector includes the electricity authorities, most public transport authorities, and State housing commissions. As already explained, the operating outlays of these non-budget authorities are excluded from the public authority outlay data presented above. It is nevertheless of interest to compare the extent of recorded non-budget outlay growth with the growth of budget outlays. A major reason for this is to assess the validity of arguments suggesting that the non-budget sector has expanded more rapidly in recent years because of government attempts to expand in an environment of increasingly constrained budget outlays.

Table 4 sheds some light on this question. In assessing these data, it is important to remember that capital spending is much more important in non-budget outlays than it is in budget outlays: in 1984-85 for example, 45.5 per cent of Commonwealth and 52.5 per cent of State non-budget outlays were capital in nature. Trends in non-budget outlays are thus heavily influenced by the general movement away from capital spending in the public sector as a whole that has already been mentioned.

Table 4 indicates that non-budget outlays are a much higher proportion of budget outlays in the State government sector than in the Commonwealth sector. Over the last decade, there has been a general downward trend in the relative importance of Commonwealth non-budget outlays, although there have been considerable fluctuations from year to year. The picture is somewhat different for the States, where the relative importance of non-budget outlays declined until the mid-1970s but has increased again in the last decade. Furthermore, there is a noticeable trend for State non-budget sector outlays to grow in relative size when budget outlays are rising modestly (i.e. between 1976-77 and 1981-82), and to decline in relative size when budget outlays are rising rapidly (i.e. between 1972-73 and 1974-75). Whether these tendencies reflect those factors alluded to above is, however, difficult to assess without a more detailed study than is possible here.

**Table 4**  
**Public Sector Budget and Non-Budget Outlays**  
**(\$ million)**

	Commonwealth Sector			State Government Sector		
	Budget outlays (1)	Non-budget outlays (2)	(2) as a %age of (1)	Budget outlays (3)	Non-budget outlays (4)	(4) as a %age (3)
1970-71	8102	na	—	4132	1182	28.6
1971-72	9047	na	—	4814	1324	27.5
1972-73	10190	na	—	5450	1361	25.0
1973-74	12229	na	—	6566	1573	24.0
1974-75	17839	na	—	9445	2092	22.1
1975-76	21787	2124	9.7	11675	2406	20.6
1976-77	24023	2286	9.5	13209	2719	20.6
1977-78	26684	2356	8.8	<u>14815</u>	3158	21.3
1978-79	<u>28211</u>	2087	7.2	17228	3555	20.6
1979-80	31841	2471	7.8	18915	4064	21.5
1980-81	36333	2695	7.4	21732	4946	22.8
1981-82	41514	3322	8.0	24133	5857	24.3
1982-83	49131	3914	8.0	28238	7855	27.8
1983-84	56840	4526	8.0	32015	7721	24.1
1984-85(a)	64221	4291	6.7	35987	8937	24.8
1985-86(b)	69430	5353	7.7	39661	9703	24.5

Notes: Underlining indicates series breaks due to data revisions or changes in data source.

(a) Provisional. (b) Forward estimates.

Sources: ABS, *Government Financial Estimates, Australia 1985-86*, Catalogue No. 5501.0, and earlier versions; *Budget Papers No. 1*, Statement No. 6:1986-87 and earlier versions.

### III. PUBLIC SECTOR EMPLOYMENT

The ratio of total outlays to GDP provides a useful summary measure of the size of government, although it does not truly reflect the extent to which government absorbs resources that would otherwise be available to the private sector. An alternative measure that addresses this issue more directly is the share of public sector employment in total employment. Since wage and salary payments account for some 15 per

cent of public sector outlays, movements in these two measures will not be independent. However, the compositional changes in outlays already noted, combined with the different labour intensities of different types of outlay, will ensure that the relation between public sector employment and outlays will by no means be stable. Of particular relevance here is the growth in the relative importance of transfer payments in total outlays, since there is no employment associated with this category of outlay.

Trends in public sector employment thus provide useful additional information on the size of government over and above that indicated by outlay trends alone. Furthermore, the relative size of public sector employment will influence the impact of the public sector on the demand for different categories of labour, the structure of employment opportunities in the labour market, and wage relativities between occupations and industries, between full-time and part-time workers, and between male and female employees.

As in the case of outlays, no single measure of the public sector employment share will be appropriate for all purposes. The measure selected will differ according to whether adjustments are made for part-time work by expressing employment levels on a full-time equivalent basis, as well as according to which particular measure is selected for the denominator of the share. There is also the question of whether to include the defence forces in the estimates or concentrate on civilian employment only. Rather than pre-judge the issues raised by such specific definitional questions, a number of alternative measures will be presented and discussed. It is perhaps worth emphasising at this stage that the range of alternative measures of the public sector employment share goes some way towards explaining the quite bewildering array of estimates that have emerged in recent public debate on this question. For this reason alone, a detailed discussion of alternative estimates is worthwhile.

The most common measure of the relative size of public sector employment includes civilian employees only. Data in this form are published by the ABS, and it should be noted that they include employment in both general government and public enterprises. Inclusion of the latter means that this measure of public sector employment is broader than that for most other countries where public enterprise employment is not included. The significance of this observation will be returned to in the following Section. Public sector employment is most commonly expressed relative to either total employees (Stanford and Jackson, 1978) or total employment (Groenewegen, 1984).

Trends in both measures are presented in Table 5. In March 1986, public sector civilian employment amounted to just over 1.7 million,

Table 5  
Public Sector and Private Sector Civilian Employment Trends, 1966-86  
(thousands)

June	Commonwealth(a) Total	Public Service	State(a)	Local	Total Public Sector (1)	Private Sector(b) (2)	Total Wage & Salary Earners (3)=(1)+(2)	Total Em- ployment (4)	(1) as a %age of (3)	(1) as a %age of (4)
1966	281.5	189.3	565.8	99.5	946.8	2937.7	3884.5	4824	24.4	19.6
1967	295.2	199.6	576.1	99.3	970.6	3020.8	3991.4	4933	24.3	19.7
1968	305.4	208.1	592.8	103.8	1002.0	3123.4	4125.4	5056	24.3	19.8
1969	315.6	214.9	608.7	103.0	1027.3	3247.6	4274.9	5183	24.0	19.8
1970	329.4	225.0	623.7	104.9	1058.0	3392.0	4450.0	5396	23.8	19.6
1971	338.7	231.4	755.5	107.4	1201.6	3391.0	4592.6	5516	26.2	21.8
1972	346.3	238.8	781.6	118.3	1246.2	3389.1	4635.3	5610	26.9	22.2
1973	360.2	248.9	803.2	122.9	1286.4	3484.5	4770.9	5783	27.0	22.2
1974	378.7	260.5	839.5	116.7	1334.9	3642.9	4977.8	5855	26.8	22.8
1975	398.7	271.4	895.9	141.0	1435.7	3494.2	4929.9	5841	29.1	24.6
1976	391.0	152.4(c)	919.5	121.3	1431.7	3501.1	4932.8	5898	29.0	24.3
1977	388.8	152.0	952.5	124.0	1465.2	3471.6	4936.8	5995	29.7	24.4
1978	402.1	153.5	968.2	126.9	1497.2	3424.6	4921.8	6005	30.4	24.9
1979	395.9	148.7	991.7	127.5	1515.1	3465.9	4981.0	6078	30.4	24.9
1980	396.5	148.5	1005.4	129.8	1531.7	na	na	6281	na	24.4
1981	402.8	149.7	1014.5	130.2	1547.5	na	na	6394	na	24.2
1982	402.1	149.1	1024.0	133.4	1559.5	na	na	6379	na	24.4
1983(d)	408.5	157.6	1080.2	141.8	1630.6	3412.9	5043.5	6295	32.3	25.9

1984	421.9	165.3	1080.9	152.8	1655.6	3455.5	5111.1	6462	32.4	25.6
1985	434.3	169.3	1119.2	154.7	1708.1	3669.2	5377.3	6670	31.8	25.6
1986(e)	434.2	169.6(f)	1136.4	155.9	1726.5	3854.7	5581.2	6961	30.9	24.8

Annual  
average  
growth  
rate (%)

2.19	-0.55	3.55	2.27	3.05	1.37	1.83	1.86	—	—
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- Notes: (a) After 1978, government employees in the Northern Territory are included with the figures for the States; prior to this they were included in the Commonwealth figures.  
 (b) This series is based on payroll tax data until 1979, and on a quarterly survey of some 20 000 private employers since 1983.  
 (c) The drop in public service employment in 1976 reflects the transfer of functions to Australia Post and Telecom out of the Public Service Act.  
 (d) Series break in 1983, which adds some 47 000 employees to the public sector, mainly at the State level; 1983 figures are for July.  
 (e) March.  
 (f) Estimated by the author.

Sources: ABS, *Civilian Employees, Australia June 1966 to June 1979* (6214.0); ABS, *Employed Wage and Salary Earners, Australia* (6248.0); ABS, *The Labour Force, Australia* (6203.0); Public Service Board, *Statistical Yearbook*, various issues.

almost 31 per cent of all civilian employees or 25 per cent of total civilian employment. Over the last 20 years, the public sector has increased its share of total civilian employees by 6.5 percentage points, and of total civilian employment by 5.2 percentage points. The increase in both measures is below the increase in the share of public sector outlays in GDP, but above the increase in the share of public sector net expenditure on goods and services in GDP. Much of the growth in relative public sector employment took place in the years 1970-72 and 1974-78.

Since 1978, public sector employment has grown in line with total civilian employment, although this period has seen a faster growth in State and local authority employment than in Commonwealth employment. Over the last 20 years, the composition of public sector employment among Commonwealth, State and local authorities has shifted from approximately 30:60:10 in 1966 to 25:66:9 in 1986. These changes do not reflect changes in the relative importance of total outlays at each level of government, but rather the different composition of outlays among the three levels (cf. Table 3). The broad orders of magnitude indicated in Table 5 and the tendency for State authority employment to expand most rapidly are both consistent with the earlier trends identified and discussed in research by Stanford and Jackson (1978).

As indicated above, the employment data in Table 5 include both general government and public enterprise employees. Over the last three years, the ABS has classified total public sector employees by industry (using the Australian SIC listings), and these data allow the size of general government employment to be estimated and identified separately from public enterprise employment. Because of the inherent uncertainties of such an exercise, two estimates have been calculated. The first — the 'lower bound' estimate — assumes that general government is solely responsible for all public sector employment in Agriculture, Forestry, Fishing and Hunting; Public Administration and Defence; and Community Services. Public enterprises are assumed to employ all remaining public sector employees. The second — the 'reasonable' estimate — assumes that in addition to the 'lower bound' estimate, 10 per cent of all remaining public sector employees are employed by general government. Although this 10 per cent figure is somewhat arbitrary, it is probably closer to the mark than the zero figure implied by the 'lower bound' estimate.

The resulting estimates, shown in Table 6, suggest that general government employment currently accounts for between 1.07 million and 1.13 million employees, or between 61.8 and 65.6 per cent of total public sector employment. By implication, public enterprise employment lies in the range 595 000 to 660 000 employees. Not surprisingly, the general government share in total employment shows a

Table 6  
**Estimated General Government Employment**

	1983		1984		1985		1986
	July	Dec.	June	Dec.	June	Dec.	March
<b>'Lower bound' estimate:</b>							
•thousands	989.3	984.0	1028.2	1011.2	1056.8	1038.3	1066.8
•%age of public sector employees	60.7	60.3	61.2	60.8	61.7	61.1	61.8
•%age of all employees	19.6	19.2	20.1	19.2	19.7	18.8	19.1
•%age of total employment	15.7	15.2	15.9	15.3	15.8	15.0	15.3
<b>'Reasonable' estimate:</b>							
•thousands	1053.4	1048.7	1093.3	1076.4	1122.5	1104.5	1132.8
•%age of public sector employees	64.6	64.3	65.1	64.7	65.5	65.0	65.6
•%age of all employees	20.9	20.5	21.4	20.5	20.9	20.0	20.3
•%age of total employment	16.7	16.2	16.9	16.3	16.8	16.0	16.3

Note: The 'lower bound' estimate assumes 100 per cent general government employment in public sector employment in the following industries: Agriculture, Forestry, Fishing and Hunting; Public Administration and Defence; and Community Services.

The 'reasonable' estimate assumes, in addition to the 'lower bound' estimate, that 10 per cent of all remaining public sector employees are in general government.

Sources: ABS, *Employed Wage and Salary Earners, Australia* (6248.0); ABS, *The Labour Force, Australia* (6203.0).

strong seasonal pattern, although it has declined since mid-1984. This decline explains much, but not all, of the overall decline in relative public sector employment in the last two years (cf. Table 5). It follows by implication that this period has also thus seen a slight decline in the share of public enterprise employment in total employment.

Finally, by applying the techniques outlined above, it is possible to estimate, for recent quarters, a breakdown of general government

employment by level of government. The resulting estimates (Table 7) indicate the importance of State government in total general government employment, a similar tendency to that already identified for the public sector as a whole.

**Table 7**  
**Public Sector and General Government Employment**  
**by Level of Government, March 1986**

	'Lower bound' estimate		'Reasonable' estimate	
	thousands	per cent	thousands	per cent
<b>General Government:</b>				
Commonwealth	163.9	9.5	190.9	11.1
States	774.8	44.9	811.0	47.0
Local	128.1	7.4	130.9	7.6
Total	1066.8	61.8	1132.8	65.6
Other public sector employees	659.7	38.2	593.7	34.4
Total public sector employees	1726.5	100.0	1726.5	100.0

Notes: see Notes to Table 6.

Sources: ABS, *Employed Wage and Salary Earners, Australia* (8248.0).

#### IV. SOME INTERNATIONAL COMPARISONS

It is evident from the discussion in the previous Sections that conventional measures of the size and growth of the public sector in Australia raise a number of important conceptual and measurement issues. Not surprisingly, such issues are compounded when attempting to derive measures of the size of government that are comparable across a range of countries. The most reliable, consistent and comprehensive data for such purposes are those produced under the SNA framework developed by the United Nations and published regularly by the OECD. Even with these data there are a number of differences with regard to how certain outlays are categorised into functional components. However, the aggregate focus in this paper means that such problems do not arise to any great extent in practice when measuring the overall size of government in a National Accounting framework.

More important is the problem alluded to in the Introduction, and discussed in more detail below, that government activities as recorded in

the SNA represent but one aspect of overall public sector intervention in the economy. To the extent that governments seek to achieve their objectives in ways not captured adequately, if at all, in National Accounts measures of government outlays, the comparability of such outlay data will itself be compromised. At the current time, there is little that can be done to overcome these difficulties, particularly since there are few reliable estimates of the extent of government 'off-budget' activities and none that are comparable across countries.

As a recent OECD study noted in this context:

Despite considerable efforts made by national accountants, data are often lacking or not suitable for certain types of economic analysis. There are inconsistencies across countries rendering international comparisons difficult. The scope of public sector activity extends beyond expenditures and revenues as estimated by national accountants. It also encompasses 'off-budget' activities such as tax expenditures and government regulation ... [whose] existence raises genuine conceptual problems in defining and measuring the full scope of public sector activity within individual countries, and further compounds the difficulties of cross-country comparisons. (Saunders and Klau, 1985:27)

Such problems should be borne in mind when assessing the comparative results presented below.

There is one additional important point to note in the context of international comparisons of the size of government. While the countries that constitute the OECD share basic similarities in terms of adherence to the general principles of free enterprise democratic constitutions, they differ in many significant ways in terms of the details of their economic, social, political and historical structures. To the extent that such differences are reflected in differing demands for government provision of goods, services and cash transfers, and in the ways in which the economic and political processes translate these demands into action, comparisons of public sector size do not strictly compare like with like. While such comparisons are both interesting and informative, basing prescriptive judgments for individual countries on them is not warranted. To the extent that such judgments are made, international comparisons of the size of government can be positively harmful and misleading.

This line of argument suggests that a more meaningful way of making international comparisons of the size of government should take some account of those differences between countries that affect

government size. In some recent research by the author (Saunders, 1986) a methodology is developed that attempts to do this for the share of general government outlays in GDP in OECD countries. Although it would be inappropriate to dwell on the details of these methods, it is worth noting that the comparisons that emerge are quite different from those based on direct comparisons of government outlays (see in particular Saunders, 1986:Tables 1 and 7). Again, therefore, it is important not to lose sight of such considerations when making international comparisons of the size of government.

It is also important to emphasise that the OECD SNA data refer to general government outlays, a narrower concept of government than the public sector as defined and discussed in Sections II and III above. The main difference between the two relates to the treatment of public enterprises. The OECD data exclude most public enterprises, except those 'which mainly produce goods and services for government itself or primarily sell goods and services to the public on a small scale' (OECD, *Annual National Accounts, Vol. II, 1970-1982*, p. 518). While this concept of general government corresponds broadly to the concept of general government enterprises utilised in the Australian National Accounts, it does not correspond to the budget sector as defined in the administrative sector classification for which data are published. The distinction here depends upon whether the day-to-day transactions of public trading enterprise are recorded in the public accounts or are conducted independently of them (see ABS, 1984:4-5). Aside from these considerations, there are many conceptual problems in deciding whether an enterprise is public or not, as emphasised by Pathirane and Blades (1982). These difficulties lead to different definitions of public enterprises across countries, and help explain their exclusion from the OECD general government data.

The effect of these definitional differences is best illustrated by comparing the public sector outlay figures presented above in Table 1 with those derived from the OECD SNA data on general government outlays. Expressing the latter as a percentage of GDP, the resulting estimates for Australia are 25.4 per cent in 1970-71, 32.3 per cent in 1975-76 and 36.3 per cent in 1982-83. The corresponding ABS estimates of public sector outlays relative to GDP are 31.5 per cent, 38.3 per cent and 42.8 per cent, respectively. The OECD general government outlay data thus understate the Australian National Accounts public sector outlay data by some 15 per cent. It should not, of course, be concluded from this that the OECD figures for Australia should be revised upwards accordingly. Such adjustments would then make the Australian data inconsistent with the data for other countries, where, no doubt, similar considerations apply. In so doing, the comparative nature of the OECD data, one of their main strengths, would be undermined.

The top half of Table 8 provides the latest available data for a range

of OECD countries on the percentage share of total general government outlays in GDP and trends over the last two decades. The main message conveyed by these comparisons is well-known and will not be dwelt on at any great length. Suffice it to say that in comparative terms general government outlays relative to GDP are low in Australia relative to most OECD countries: in 1983 — the latest year for which the Australian OECD data are available — the outlay ratio in Australia was much the same as that in many Northern European countries two decades previously. The main reason for this is the low level of transfer payments in Australia, which amounted to 15.5 per cent of GDP in 1983, compared with 22.0 per cent in Canada, 32.2 per cent in France, 24.3 per cent in Germany, 17.5 per cent in Japan, 19.8 per cent in Spain (in 1982), 32.9 per cent in Sweden, 22.3 per cent in the United Kingdom and 17.6 per cent in the United States.

In Part B of Table 8, outlays are expressed in real per capita terms using 1980 US dollar exchange rates and price levels. On this measure, the size of government in Australia is again low by OECD standards, real per capita outlays being only one-third of those in Sweden, half as large as those in Germany, three-quarters of those in the United Kingdom and four-fifths of those in the United States. However, with the exception of Sweden, real per capita government outlays grew faster in Australia over the period than in each of these other countries. Indeed, their growth in Australia exceeded the growth of real GDP per capita (again expressed in 1980 US dollars) by some two per cent per annum.

The other aspect of international comparisons of the size of government relates to government employment. Considerable attention has been focused in recent discussions in Australia (e.g. 'PS Octopus Under Attack', 15 September 1986) on comparisons published by the OECD that appear to show Australia has a relatively high proportion of total employment in the general government sector. Figures provided in Table 13 of Saunders and Klau (1985), for example, show the general government employment share in Australia in 1982 to be 25.4 per cent, well above the OECD average of 18.4 per cent and exceeded in only Denmark and Sweden. Similar orders of magnitude are to be found in the earlier published work of the OECD (1982), in the work of individuals within the OECD (Martin, 1982), and Pathirane and Blades (1982), and also in a study published by the IMF (Heller and Tait, 1984). In conjunction with evidence that government outlays are a smaller percentage of GDP in Australia than in most other OECD countries, the high employment share in Australia has led many commentators to conclude that government employment levels are excessive and in need of curtailment. The IMF study also observed that government employment in Australia was higher in 1980 than experience in other countries might suggest. (Heller and Tait, 1984:30-1).

**Table 8**  
**International Comparisons of General Government Outlays**

**A: Total Outlays as a Percentage of GDP**

	1965	1975	1984	Annual %age increase
Australia	25.6	32.7	36.4(a)	1.97
Canada	29.1	40.8	47.5	2.61
France	38.4	43.5	52.6	1.66
Germany	36.6	48.9	48.2	1.46
Japan	na	27.3	33.1	3.89
Spain	19.6	24.7	36.6(b)	3.74
Sweden	36.1	48.9	63.7	3.03
United Kingdom	36.1	46.4	48.0	1.51
United States	27.9	35.6	38.1(a)	1.75

**B: Real Per Capita General Government Outlays(c)**  
**(1980 US\$)**

	1965	1975	1983	Real per capita GDP, 1983 (1980 US\$)	Annual %age increase (1965-83) in: Real per capita outlays	Real per capita GDP
Australia	1718	2928	3202	9686	4.07	2.06
Canada	2029	3961	4412	10672	5.13	2.39
France	2781	4606	5661	12425	4.86	3.04
Germany	3144	5421	6393	13272	4.05	2.45
Japan	na	1983	2860	9653	8.06	3.43
Spain	664	1336	1835	5732	6.92	3.07
Sweden	3905	6937	9202	15354	5.46	1.97
United Kingdom	2595	4056	4273	9846	3.30	1.76
United States	2416	3636	3995	11481	3.35	1.58

Notes: (a) 1983; (b) 1982; (c) Converted using 1980 US\$ exchange rates and price levels.

Sources: OECD, *Annual National Accounts, 1960-1983* and *Economic Outlook* May 1988.

Aside from the point made earlier on the dangers of drawing prescriptive conclusions from such international comparisons, there is a much more fundamental weakness with this argument that needs to be redressed. The Australian government employment data used in these OECD and IMF comparisons refer to employment in **all public authorities** and are therefore much broader in scope than the general government employment data for other OECD countries. This point was acknowledged explicitly in footnotes to the relevant Tables in both OECD (1982) and Saunders and Klau (1985), but seems to have been missed by many readers. Feeling to some extent responsible for creating these problems, it is perhaps incumbent upon me to help resolve them by providing the appropriate data for more relevant comparisons.

Estimates of the level of employment in general government in Australia have been derived and presented in Section III above. The estimates shown in Tables 6 and 7 need to be adjusted further to make them comparable with other countries, by including defence force personnel in both government and total employment. With this adjustment, the 'reasonable' estimate of the general government share in total employment (including defence forces) is 17.7 per cent in July 1983, falling slightly to 17.1 per cent by March 1986. Table 9 compares the former figure with the 1983 general government employment share for other OECD countries for which data are available. The Australian figure can be seen to be below the average share of 19.0 per cent for those countries shown. However, in employment terms Australia is much closer to the OECD average than it is in outlay terms. Does not this comparison therefore confirm the views on excessive government employment referred to above?

In considering the relation between government employment and government outlays, it is necessary to exclude outlays on transfer payments since these involve no employment on the part of government (except, of course, those required to administer such transfer payments, but payment to these employees of government is recorded as part of government final consumption expenditure). This point is important since, as already noted, transfer payments in Australia are lower relative to GDP than in most other OECD countries. Their exclusion thus causes Australian government outlays on goods and services alone — current and capital — expressed relative to GDP, to be much closer to the OECD average than are total outlays (Table 9). A comparison of general government employment with general government outlays on goods and services shows Australia somewhat below the OECD average in both regards (Chart 3). It is true that Australia lies slightly above the estimated regression line based on these data, but this deviation is unlikely to be greater than the margin of error involved in deriving the estimate of general government employment.

Table 9  
**General Government Employment and Expenditure on  
 Goods and Services in 1983**

	Expenditure on goods and services as a %age of GDP	General government employment as a %age of total employment
Australia	20.9	17.7(a)
Austria (1982)	24.4	19.2
Belgium (1982)	21.4	19.5
Canada (1982)	24.7	19.9
Denmark	30.6	31.4
Finland	23.6	19.4
France	19.8	19.2
Germany	24.1	15.9
Italy	24.8	15.6
Japan	18.8	6.5
Netherlands	22.5	16.1
Norway	24.3	23.6
Portugal (1981)	20.1	9.0
Sweden	33.3	32.3
United Kingdom	25.0	22.1
United States	20.5	16.5
<b>Average</b>	<b>23.6</b>	<b>19.0</b>

Note: (a) Australian estimate described in the text.

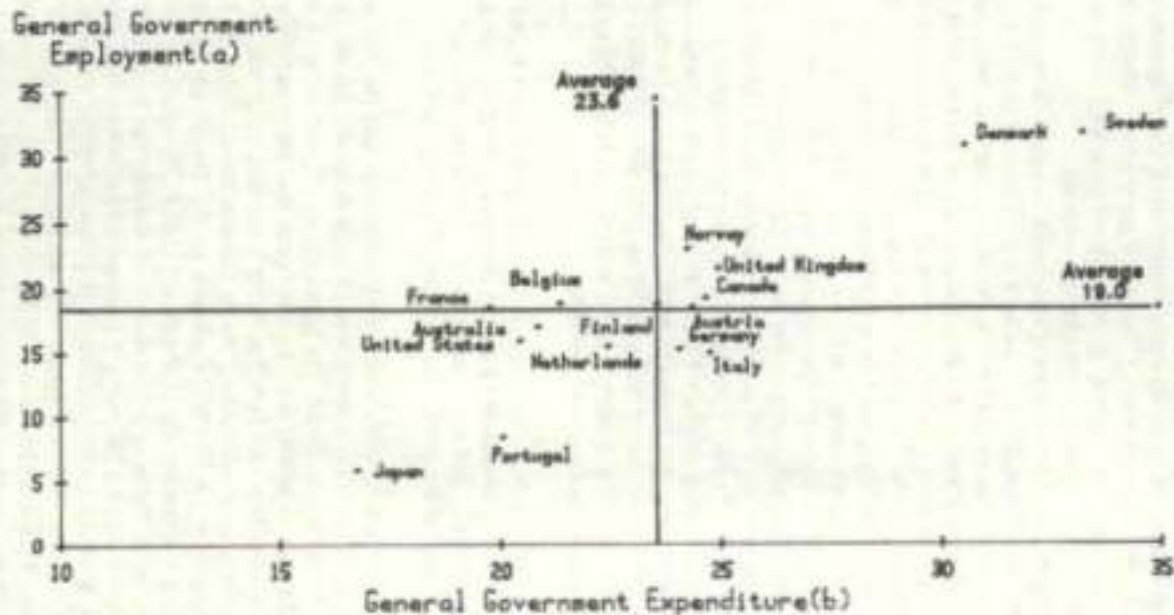
Source: OECD, *Annual National Accounts 1971-1983* and *Economic Outlook*, May 1986.

Thus it would appear that when appropriate and relevant comparisons are made, the evidence does not sustain the view that government employment in Australia is above the OECD average. Nor, more importantly, is it significantly above what one would anticipate given the share of government expenditure on goods and services in GDP relative to other OECD countries.

## V. TAX EXPENDITURES

As already emphasised, the degree of government intervention in the economy extends beyond those measures reflected in statistics on government outlays and employment. Among the more important of such interventions are tax expenditures, regulatory activity and government lending and loan guarantees. Attention will focus on the

Chart 3  
 General Government Employment and Expenditure on Goods  
 and Services In 1983



(a) Percentage of Total Employment

(b) Goods and Services as a Percentage of GDP

first two of these in this and the following Section; for a discussion of the third see Break (1982). As noted in the Introduction, the discussion will emphasise the costs to the government of these activities, not their overall cost to the economy. The latter perspective, while an important and legitimate issue, extends beyond the scope of this paper and is in any case the subject of other papers in this volume.

Within the narrower budgetary cost context, however, there are concerns that these activities have grown larger and have been allowed to persist longer than would have been the case had they been subject to the same degree of scrutiny and assessment that outlays face each year during the budget process. Whether or not this has in fact been the case is virtually impossible to decide, but few would argue with the general principle of moving towards more uniform assessment procedures for all elements of government activity. Under current arrangements in Australia, the Cabinet's Expenditure Review Committee examines new tax expenditure proposals in the same way as new direct expenditures, but this process does not extend to tax expenditures already in existence. A recent report by the Office of EPAC suggested a number of alternative methods designed to extend these arrangements to ensure that all tax expenditures become subject to review and assessment processes similar to those that cover direct outlays (Office of EPAC, 1986a:17-18).

Tax expenditures were defined in the Draft White Paper (*Reform of the Australian Tax System*, 1985) as:

Reliefs or concessions in the tax system (not being a basic component of the tax structure) which reduce tax liability and have effect on the Government's budget similar to direct expenditures. (*Reform*, 1985:xiii)

Problems arise with both the identification and the measurement of tax expenditures. Their identification is predicated upon the specification of the basic or benchmark tax structure, divergencies from which then constitute tax expenditures. To the extent that there are different views of what constitutes the benchmark tax structure, estimates of the size of tax expenditures will differ. As an illustration of this, the Treasury in its submission on Tax Expenditures to the House of Representatives Standing Committee on Expenditure (HRSCE) estimated the revenue forgone as a result of superannuation-related tax expenditures to be \$1720 million in 1981-82. In another submission, the Department of Social Security (DSS) estimated the cost of these concessions to be \$2405 million. The difference between the two figures — almost \$700 million — reflects the much broader scope of the DSS estimates, which included tax concessions in the form of lower tax rates on unfunded superannuation pensions, unfunded 'golden handshakes', and, most importantly, the concessional taxation of superannuation lump sums.

This last item alone was estimated by the DSS to have cost \$475 million in 1981-82. (The reason for these differences has recently been addressed by the Treasury [1986] in Attachment B of its *Tax Expenditures Statement*, to which interested readers are referred.)

Aside from the question of the scope of superannuation-related tax expenditures, there is the more fundamental and general question of the appropriate counterfactual position to assume. Many critics have taken issue with the Treasury estimates (e.g. Dixon, 1986), with the result that considerable uncertainty surrounds the magnitude of tax expenditures, although there is general agreement that they are substantial. Estimates of the superannuation-related tax expenditures alone put them at \$2.61 billion in 1984-85 (Treasury, 1986:Table 3, p.20), equivalent to 46 per cent of budget outlays on age pensions and allowances in that year.

Not only is the concept of the benchmark tax structure inherently ambiguous, its specific dimensions are likely to change over time. To give an example of this, employer-provided fringe benefits that are exempt from the new fringe benefits tax might now be regarded as tax expenditures, since taxation of fringe benefits has now become part of the normal tax structure. However, prior to the introduction of the tax, fringe benefits were not generally regarded as tax expenditures when estimating their cost, since their exclusion from taxable income was seen as part of the benchmark tax structure. Such considerations can have important implications for evaluating trends over time in the cost of tax expenditures, and also for international comparisons. Indeed in this latter case there currently exists no agreed upon method for identifying and measuring tax expenditures.

Most estimates of the cost of tax expenditures adopt a 'revenue forgone' approach under which an estimate is made of the amount by which tax revenue is reduced as a result of each tax concession. This method has been used in Australia by the Treasury in its tax expenditure estimates. It ignores behavioural changes induced by the existence of the tax concession, and thus may produce a misleading estimate of the gain to revenue were the concession to be removed. In this context, it is worth recalling that many tax expenditures are introduced with the precise intention of influencing behaviour in favour of those activities given preferential tax treatment. There is the additional problem that individual tax expenditure estimates may not be independent, and in principle should not be added together. Removal of one concession, for example, may increase taxable income and hence raise the costs of a second concession. Such considerations do not, however, seem to be a serious cause for concern in practice. Nevertheless, as a result of such problems the Congressional Budget Office in the United States has recently started presenting tax expenditure estimates on an 'outlay-equivalent' basis. This involves estimating the amount of pre-tax

dollars required to leave post-tax incomes the same as with existing tax expenditures.

However the above difficulties are resolved, the existence of tax expenditures suggests that the size of government is larger than implied by outlays alone. Even this proposition can, however, be questioned (see Break, 1982), since it depends to some extent upon government behaviour. If, for example, the view is taken that tax expenditures represent favours bestowed on interest groups that would not be tolerated as direct outlays, then it can be argued that abolition of the tax expenditures would have no effect on direct outlays but would allow the same tax revenue to be raised at lower tax rates. On this view, tax expenditures are not properly part of the measure of the size of government and should not be added to direct outlays. An alternative view would be that elimination of tax expenditures would lead to pressures for outlay increases of a similar magnitude, in which case the sum of direct outlays and tax expenditures provides a better estimate of the size of government than direct outlays alone. If the truth lies somewhere between these two views, then some proportion of the cost of tax expenditures should be added to direct expenditures. This is a somewhat uncomfortable conclusion, which again derives from different views about how the measurements should be made. It does, however, highlight the considerable conceptual problems faced when attempting to incorporate broader aspects of government activity into measures of the size of the public sector.

Some longer-run trends in the revenue cost of certain tax expenditures in the income tax system are shown in Table 10. The coverage of these data is by no means comprehensive, as they include only those concessions in the income tax system that can clearly be identified as providing assistance to either individuals (e.g. tax rebates) or industry (e.g. accelerated depreciation provisions; investment allowances). Many other tax expenditures — those related to superannuation benefits for example — are excluded. On the basis of this evidence, there has been a clear downward trend in the cost of these identified tax expenditures relative to direct outlays in the decade up to 1982-83. Despite this, their cost remained substantial, amounting in 1982-83 to 7.6 per cent of Commonwealth budget outlays, 11.2 per cent of income tax revenue, or 70.4 per cent of the Commonwealth budget deficit. Much of the overall downward trend occurred in the first half of the 1970s, and more recently the cost of these tax expenditures has risen faster than direct outlays. Table 10 illustrates this increase for those providing assistance to individuals, and information in the Draft White Paper indicates an increase in tax expenditures providing assistance to (non-financial) industries approaching \$1 billion by 1984-85.

Table 10  
**Estimated Cost of Commonwealth Budget Tax Expenditures in Australia**

	Individuals		Industry		(3)= (1)+(2)
	\$m	%age of budget outlays (1)	\$m	%age of budget outlays (2)	
1970-71	788	9.7	279	3.4	13.1
1975-76	1390	6.4	146	0.7	7.1
1980-81	1173	3.2	689	1.9	5.1
1982-83	2443	5.0	688	1.4	6.4

Note: These estimates include only those tax expenditures that have been documented in the Budget Papers. They exclude, for example, many superannuation-related items.

Source: Office of EPAC (1988:9, Table 1).

More comprehensive estimates of the cost of tax expenditures has recently been provided by the Treasury (1986) in its *Tax Expenditures Statement*, which arose out of the recommendations of the HRSCE Report on Taxation Expenditures. These estimates have been prepared on a functional basis and include concessions arising from the income tax, interest withholding tax, dividend withholding tax, the departure tax, and excise duties. Other tax expenditure provisions noted in the Treasury Report but not costed include the capital gains provisions of the income tax, the bank account debits tax, and the 2 per cent revenue duty (customs tariff). Those tax expenditures that were costed are summarised in Table 11. On this basis, tax expenditures cost over \$7.3 billion in 1984-85, equivalent to 11.5 per cent of budget outlays and almost 10 per cent in excess of the Commonwealth budget deficit. Over 85 per cent of the total cost fell in two functional areas, social security and welfare, and industry assistance and development, reflecting measures to encourage private savings through superannuation funds and to encourage private investment through various depreciation provisions and the (now-abolished) investment allowance.

Three aspects of this discussion are worth re-emphasising: First, there are many conceptual and practical difficulties involved in identifying and estimating the cost of the many tax expenditures that exist in Australia. In its recent report, the Treasury listed no fewer than 130 tax expenditures relating to the income tax system alone and a further 43 relating to the other taxes included in its analysis. For these

**Table 11**  
**Aggregate Tax Expenditures by Functional Category**

	Estimated Revenue Cost (\$m)		
	1982-83	1983-84	1984-85
Defence	26	24	26
Education	75	77	81
Health	604	47	108
Social Security & Welfare	3872	4296	4540
Housing & Community Amenities	396	203	172
Culture & Recreation	60	100	155
Economic Services			
•Industry Assistance & Development	1094	1325	1624
•Labour & Employment	24	25	30
•Other	5	5	5
General Public Services			
•Legislative Services	..	..	..
•Law, Order & Public Safety	na	na	na
•Foreign Affairs & Overseas Aid	1	11	19
•General & Scientific Research	na	na	na
•Administrative Services	4	6	7
Not Allocated to Function	415	377	485
<b>Total of Listed Items</b>	<b>6576</b>	<b>6496</b>	<b>7352</b>
Total revenue cost as a %age of:			
•Budget Outlays	13.5	11.5	11.5
•Budget Deficit	147.8	81.9	109.4
Percentage of total revenue cost due to income tax provisions			
	96.6	94.7	94.4

Notes: .. = less than \$1 million; na = not available.

Source: The Treasury, *Tax Expenditures Statement*, October 1986: Tables 1 and 3; *Budget Paper No. 1*, Statement No. 6, 1986-87.

reasons, estimates of the overall cost of tax expenditures and their disaggregation need to be treated with caution. Second, the estimation of tax expenditures has become more sophisticated and more effort has been devoted to the task in the last decade or so, with the result that trends over time are difficult to gauge with precision. Finally, despite these problems, currently-available estimates suggest that the cost of Commonwealth income tax expenditures is substantial and therefore that direct outlays alone understate the full cost and dimension of government interventions in the economy.

## VI. REGULATION

Estimating the regulatory dimension of public sector activity presents many formidable problems. These arise not so much because of the inherent difficulties of identifying the proportion of government outlays or employees that are involved in regulatory activity. Of more significance is that these estimates represent but a fraction of the overall cost to the community of such regulations. Much of the direct cost of regulation is incurred not by government itself but by those producers and consumers who are required to comply with the regulations. In addition, there are broader economic costs associated with the changing pattern of resource allocation that accompanies regulatory intervention. Estimating the overall economic costs of regulation — as opposed to the direct budgetary costs involved — is, of course, the appropriate focus for any cost-benefit analysis of their effectiveness. However, this broad perspective extends beyond the scope of this paper, and is addressed in more detail in one of the following papers.

It is most likely that estimates of the budgetary costs of regulation provide a very poor indication of the overall economic costs involved. As will become apparent, the direct budgetary costs associated with business regulation by the Commonwealth in Australia appear to be quite small, yet there is a widespread perception in sections of the community that the total economic costs are massive, far in excess of the associated benefits.

The difficulties associated with deriving an appropriate measure of the budgetary costs of regulation were emphasised in the report by Saunders and Klau (1985). After a brief review of available evidence — mainly for North America — that study concluded that 'when certain narrow measures are applied to specific examples of regulatory activity, there is evidence of upward trends' (1985:88). The study also noted changes in the form of regulatory activity in the post-war period, with a decline in the importance of vertical regulation (sector-specific measures intended to prevent the establishment of monopolies and other forms of non-competitive market conditions) relative to horizontal regulations

(intended to internalise certain externalities by altering the outcome of private market decisions). These two forms of regulation broadly correspond to what Pincus and Withers (1983) refer to as economic regulation and social regulation. The growth in the latter form of regulation, intended to improve workplace health and safety and environmental quality, was in response to demands similar to those that saw a rapid expansion in welfare state expenditure in the two decades up to the mid-1970s. It is similarly possible to view recent emphasis on the need to deregulate financial markets as part of a general trend towards reaffirmation of the economic benefits of increased reliance on market forces as a mechanism for allocating resources.

Aside from these broader (and important) questions, the following discussion focuses on the budgetary costs associated with business regulations in Australia. Most available research attempts to estimate either the outlays on, or employment in, government agencies responsible for overseeing regulations. Other measures include the number of agencies themselves, the number of regulations, or the page length of the underlying regulatory legislation. However, while these measures may indicate broad trends over time, they do not allow the extent of the costs of regulation to be assessed on a basis comparable with budgetary estimates of the size of government.

The first serious attempt to estimate the budgetary cost to the government of its agencies responsible for regulation of private business activity was provided by the Confederation of Australian Industries (CAI) in 1980. Their estimates suggested that some 12 500 public servants were employed in Commonwealth regulatory agencies in 1979, at a direct cost to the government of some \$300 million. More recently, the Business Regulation Review Unit (BRRU, 1986a) has undertaken a similar exercise for 1985-86. The resulting regulatory employment estimates, shown in Table 12, indicate some 16 400 public servants involved in regulation of business activities. Of these, 11 200 or 68 per cent were employed in five portfolio areas: Aviation; Employment and Industrial Relations; Health; Industry, Technology and Commerce; and Primary Industry. Regulatory staff accounted for 3.8 per cent of total Commonwealth government employment or 9.7 per cent of public service employees in 1985-86 (cf. Table 5); the CAI estimates suggest corresponding employment shares of 3.2 per cent and 8.4 per cent, respectively, in 1979.

On the basis of an average service-wide salary estimate, the cost of employing these regulatory staff in 1985-86 was estimated by the BRRU to be \$406 million, or 0.6 per cent of total Commonwealth budget outlays. Applying a 'rule of thumb' to allow a 75 per cent addition for overheads, these estimates increase to \$710 million, or 1.0 per cent of budget outlays. To put this figure in some perspective, it is well below the estimated revenue forgone due to tax expenditures that

Table 12  
**Commonwealth Business Regulatory Staff Estimates  
 1985-86**

<i>Portfolio</i>	Estimated Regulatory Staff (1)	Average Staffing Level (Staff Years) (2)	(1) as a %age of (2)
Aboriginal Affairs	155	784.7	19.8
Arts, Heritage & Environment	409	2645.5	15.5
Attorney-Generals	563	4165.2	13.5
Aviation	1330	10203.0	13.0
Communications	689	1492.4	46.2
Community Services	76	2763.4	2.7
Defence	50	40560.8	0.1
Employment & Industrial Relations	1242	9070.3	13.7
Finance	105	2092.6	5.0
Foreign Affairs	10	4892.7	0.2
Health	1819	4460.9	40.8
Housing & Construction	35	8997.0	0.4
Immigration & Ethnic Affairs	112	2307.3	4.9
Industry, Technology & Commerce	3307	6511.5	50.8
Local Government & Administrative Services	15	5009.0	0.3
Primary Industry	3500	3571.3	98.0
Prime Minister & Cabinet	181	1972.5	9.2
Resources & Energy	301	2691.6	11.2
Science	842	9500.1	8.9
Trade	152	1825.4	8.3
Transport	829	1629.5	50.9
Treasury	718	21515.8	3.3
<b>TOTAL</b>	<b>16430</b>	<b>202305.4(a)</b>	<b>8.1</b>

Note: (a) includes staffing in portfolios with no identified regulatory staff.

Sources: Business Regulation Review Unit (1986a), Attachment A; Budget Paper No. 1, 1986-87: Table 2, p.5.

provide assistance to industry (cf. Section 5 and Table 10), although the sectoral impacts of these two measures are likely to differ. The estimated direct regulatory cost figure compares with a regulatory cost share of federal expenditure of 1.0 per cent in the United States and 1.5 per cent in Canada, both in 1977-78 (Saunders and Klau, 1985:Table 28, p.86). The regulatory employment shares in these countries in that year were 3.1 per cent and 5.9 per cent, respectively. On the basis of these estimates, it would thus appear that the direct costs of business regulation in Australia are currently of a similar order of magnitude to those existing in the United States eight years ago.

In a subsequent report, the BRRU (1986b) has suggested that inclusion of staff in the ABS, the Australian Tax Office and certain Commonwealth research agencies might double the estimated regulatory staff numbers shown in Table 11. Furthermore, State and local government business regulatory personnel might exceed Commonwealth staff by as much as 50 per cent. On this basis, total public sector regulatory employment might be as large as 80 000 or about 7 per cent of general government employment (cf. Table 6). Based on Commonwealth salaries and overheads, their total cost to government could be as high as \$3.6 billion, or 3.6 per cent of projected 1985-86 public sector outlays. Given the nature of the assumptions that underlie these estimates, it would be unwise to regard them as any more than indicative of the broad orders of magnitude involved. Clearly this is an area where more detailed and thorough research is warranted.

The above estimates of the budgetary costs of regulation are, of course, already incorporated in the outlay (and employment) statistics presented earlier. In this sense, they do not indicate the need to revise upwards these earlier estimates of government size. They do, however, refer only to the direct budgetary costs of business regulation. As already noted, the total costs of regulation include the compliance costs imposed on the regulated, and these are likely to far exceed the direct budgetary costs to the regulators.

## VII. CONCLUSIONS

This paper has concentrated on issues involved in measuring the size of the Australian public sector and how it has developed over the last two decades. It should by now be apparent that this is by no means a straightforward task and, more importantly, it is one for which there is no single all-encompassing indicator of size or growth. Based on National Accounts estimates, public sector outlays amounted in 1985-86 to 43.4 per cent of GDP, and the public sector employed just under one-quarter of the total employed workforce. When these data are converted to a form comparable with estimates for other OECD

countries, it is clear that general government outlays relative to GDP are lower in Australia than in most other OECD countries and that the government employment share is also below average.

Evidence on trends in the costs of tax expenditures and business regulations is currently not entirely reliable, although improved estimates are now available for recent years. These suggest that Commonwealth tax expenditures amounted to over 11.5 per cent of budget outlays in 1984-85, while enforcement of business regulations may currently cost the Commonwealth over \$700 million. The costs to State and local governments of business regulations may be half as much again. Uncertainties surround these estimates, reflecting the problems inherent in identifying and measuring these aspects of public sector activity.

It is, however, encouraging to see more effort being put into such exercises than was apparent five years ago. This is part of a general broadening of perceptions regarding the full scope of government activity, and a recognition that the National Accounts reflect but one element, albeit undoubtedly the major one, of the scope of the public sector. Nevertheless, the reality is that the dividing line between the public and private sectors cannot always be drawn as exactly as is often imagined. Because of this, estimating the size of the public sector may help reinforce the misleading impression that the public and private sectors are separate entities, rather than two aspects of an integrated economic system.

Throughout this paper, the emphasis has been on estimates of the budgetary cost of the public sector in terms of outlays and employment. The broader issues of the overall costs to the economy have not been canvassed, important though they are. At several stages in the argument, the borderline between these two concepts of cost is difficult to draw with precision. Despite such difficulties, it is useful to try to distinguish the positive from the normative, questions of fact from matters of opinion and judgment, however valid the latter may be. Nowhere is this more important than in the context of the debate on the size and impact of the public sector, where it is all too easy to allow judgment and perception to cloud the facts.

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**'A Vast Public Utility':  
The State in Australians'  
Experience and Expectations**

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# 'A Vast Public Utility': The State in Australians' Experience and Expectations

*Hugh Collins*

## Introduction

Australian democracy has come to look upon the State as a vast public utility, whose duty is to provide the greatest happiness for the greatest number.

This frequently quoted observation is Sir Keith Hancock's (1930:72). It provides the starting point for these reflections on Australians' experience and expectations of the state, for I follow Hancock in regarding the distinctiveness of our society's public philosophy as residing in its utilitarian character. Although not the only ingredient in the *pot au feu* of national politics, utilitarianism has, I believe, contributed the dominant flavour. Its pervasive influence is reflected in the programs of the major political parties and in the customary, even if contending, attitudes of business and labour alike.

Moreover, as the quotation from Hancock implies, it is possible to identify the particular form of utilitarianism that has captured our public mind as essentially Benthamite. That English legal philosopher's positivist individualism is stamped on the largely Chartist institutions that were created out of the 19th-century struggles over the Australian colonies' political form. The frank pursuit of individual interest, the assumption that the state could be — should be — fashioned to serve the interests of the majority of individuals, the dual emphasis upon legislation as the means of reform and parliamentary representation as the means of accountability and control: these hallmarks of Bentham's philosophical scheme are to be found in the assumptions and style of Australia's politics (Collins, 1985).

To interpret Australian politics in this light is relevant to the questions with which this volume deals. This paper first pursues some implications of this interpretation of political ideology in Australia for

the growth of government in Australia. It then asks questions about the politics of privatisation in the face of the Benthamite tradition. It concludes with some dilemmas of government and politics that the Benthamite tradition and contemporary circumstances seem to me to pose.

### **Utilitarianism and the Growth of Government in Australia**

The cluster of assumptions and values that I am characterising as Benthamism can be seen to have a direct bearing upon the growth of government, for it could be said to imply an ideological predisposition to state intervention and regulation. The agenda for public activity in Bentham's scheme is surprisingly modern: health, education and welfare — the engines of expansion in government services — are prominent (Hume, 1981). It should therefore be no surprise to find this program worked out in the social laboratory of early 20th-century Australia. A mechanical rather than an organic approach to politics also ensured that government could be seen as a contrivance, to be shaped, altered and improved to suit the practical requirements of changing circumstances. That practical dedication to individual interest and workable schemes is evident in the politics that produced the Australian federation. The founders worked with known materials readily to hand rather than appealing to classical and idealistic models.

Benthamism is an ideology that fitted well with Australia's circumstances. The state has been inseparable from Australia's social and economic experience. For its white settlers, it can be said that in Australia, by contrast with much of the history of the development of the United States, the state has preceded society. This was true not only for those colonies that began as gaols, but generally in the system of land tenure, the provision of infrastructure, and the ties with 'Home'. From the beginning of European settlement, our public and private spheres have been mixed. This has profoundly affected our social and political philosophy.

In a country of sparse settlement, frequently adverse physical conditions and great distances, reliance upon the state to provide, to sustain and to rescue seemed natural. Ports, railways, roads, bridges, water supplies, mining leases, loans: there is plenty of concrete evidence of the state's role. Even the early economic history of the country is conventionally described as 'colonial socialism', but the phrase refers to a set of relationships rather than to a definition of doctrine. As Linge shows, Australia's industrial awakening required a mix of public and private initiatives and guarantees (Linge, 1979). And, as Butlin, Barnard and Pincus demonstrate, however diverse and somewhat conflicting in its tendencies, the 20th-century pattern of government action and private interest reveals government and capitalism

to be inseparable in Australia in ways unfamiliar to Europeans or North Americans (Butlin et al., 1982).

Both capital and labour displayed utilitarian attitudes. Each expected the state to protect and promote its interests, just as the state provided the judicial framework in which their conflicts were arbitrated. A positive view of the state is evident in the programs and conduct of the major political parties. This is not to suggest that there were never conservatives opposed to all public enterprise, or socialists committed to nationalising the means of production, distribution and exchange. But, however vocal such elements may have been, and however necessary to the demonology of their political adversaries, neither captured the direction of affairs.

At the centre, the utilitarian ideology has been perfectly compatible with the demand for development that has characterised Australian politics and policies in this century especially. Governments, Labor and non-Labor alike, have not shrunk from using government to pursue that quest. (Remember that the Commonwealth Department of National Development was a Liberal creation!) The patterns of activity — and recipients of reward — have varied, but the protective influence of government has persisted. Whether in the provision of infrastructure, the guaranteeing of capital, the promotion of exports, or the impeding of imports, government has had a role. Consider how much private wealth in this country began its accumulation as the result of a public licence, a public loan, a public contract, or a public subsidy. (The subsequent pillorying of the public sector by beneficiaries of this early assistance should not surprise us. It is a perfectly ordinary hypocrisy on a par with those pathologists and barristers who insist upon privatising all the fruits of an expensive public education, or of those university professors who forget that their academic tenure and status may be more reliable as an indicator of age and gender than of academic quality.)

To describe the state as a utility is not to say that it is loved. Indeed, marking out the dominant Australian attitude as utilitarian may be reinforced by emphasising what is excluded by that vision of politics. It is to say that the state is not divinely-ordered, an object of reverence; nor is it martial, the bearer of warrior values; it is not utopian, promising the realisation of an ideal; neither is it tyrannical, inducing fear. Such heroic, or desperate, images of the state are absent from the mundane and practical rhetoric of Australian political discourse. At worst, the interest-oriented cynicism of our utilitarianism degenerates into a rather miserable cynicism, just as the mateship of a roughly egalitarian society can curdle into misanthropy.

To Australians, the functions of government have mattered more than its scale. 'Does it work?' has been the popular question. And where administration has been found faulty, the instinct has been to ask what tinkering is necessary to make it work. Nowhere is this tinkering,

the national talent for improvisation, more evident than in the mixed sphere where public and private activities overlap. The landscape of Australian administration is littered with boards, trusts, councils, advisory committees, representative agencies and so on. Among the native fauna of this administrative ecology, what is a quango but a marsupial nursed in the pouch of the state but lacking the placental connection of the ministerial department?

Two things may be said about this proliferation of administrative and advisory forms. First, this tangled growth in government has occurred largely at the invitation, indeed often at the insistence, of the governed.

Second, this pattern is true of all levels of government. The federal aspect of our political system is too often neglected in general discussions of Australian government. Yet federalism has a double significance: the interpenetration of public and private is occurring at different levels simultaneously; and the interdependence of these levels creates opportunities for conflict and collaboration across the system. The regulatory complexity of federal systems is notorious, as is their propensity for breeding bureaucracy. Paradoxically, a constitutional form often adopted to protect local domains of privacy proves ultimately to complicate and extend the realm of public activity. Australia has not escaped these consequences of its constitutional form.

Thus ideology, interests and institutions have together encouraged the growth — and affirmed the legitimacy — of government in Australia. Despite occasional symbolic or rhetorical gestures towards a reduction in the public sector (Wettenhall, 1983), governments of all persuasions have maintained the institutional infrastructure by which private capital has been supported and individual welfare delivered.

### **The Politics of Privatisation**

In the eyes of some, those who have been building a nation for a continent in Australia have constructed a state apparatus to scale. Those libertarians and public choice economists drawn to market-oriented analyses of politics will have two quarrels with Australian's notion of the state as a 'vast public utility': they will dispute the utility of government; they will be dismayed by the indication of size implied in 'vast'.

Clearly, this position is a challenge to what has been described as the ideological hegemony of Benthamite utilitarianism. Those committed to small government, privatisation and deregulation are firmly outside the orthodoxies of Australian politics. Moreover, their sharp demarcation of the private and public spheres means a direct confrontation with the broad sweep of Australian political and economic history.

What distinguishes their approach is the proposal of privatisation as a policy. Rather than serve as one instrument among many with which to prune and shape the public realm, privatisation is prescribed as a complete strategy for political order. Its program is offered as at once a remedy for the external afflictions of the national economy (permitting a renewal of internal competitiveness) and as a dose of salts for the internal system (curing the body politic of the sluggishness imposed by a bloated bureaucracy).

The reproach to orthodoxy that this movement presents has clearly found its mark. Privatisation may lie outside the dominant ideology, but it is now firmly inscribed upon the national agenda of debate. One can find — in the pages of the *IPA Review!* — the Federal Treasurer committing a Labor administration to small government (Keating, 1985–86). The lead essay in the collection of papers just published by the Chairman of the Public Service Board is devoted to small government and social justice (Wilenski, 1986). To be sure, Peter Wilenski's contribution is a vigorous rebuttal of the privatisation position, but to draw such fire is at least a sign of polemical success.

Given the apparent marginality of the privatisation school, how is this prominence to be explained?

Partly, no doubt, the climate is right. The reputation of government generally has been declining of late. Consider almost any aspect of the public realm — public finance, public health, public education, public transport, public broadcasting, public bureaucracy, public housing — and the same pattern of defensiveness, the same complaint about resource depletion, may be found. All of these areas have come under scrutiny, and there are problems aplenty in each. When few need persuading that some things are wrong, we should expect interest in any remedy confidently proposed as a certain cure.

Nor have the ideas propounded by a small number of theorists, most of whom have been favourably influenced by the policies of the Thatcher Government, been unwelcome to a powerful set of corporate interests. It is no doubt important to distinguish between the theorists and those who take advantage of them, though ultimately the philosophers cannot plead innocence about the political uses of their work. After all, who favours may be who benefits.

The privatisation movement seems to me not only to challenge the prevailing ideology in Australia, but also to fly in the face of what is known about this society and its values.

Let us begin with the British model. That the Thatcher example will fail to attract many of us is largely irrelevant, for the overriding point is that the comparison with Britain is inappropriate. The pattern of government involvement in the two societies is markedly different. Their public enterprises, for example, were undertaken or acquired for demonstrably different reasons, in different sectors of industry, at

different stages. The political context of the privatisation debate is also significantly different, given the distinctive party ideologies and social composition of each polity. There is, finally, a profound difference in constitutional context. The strategy of privatisation is a simpler task in a unitary state than it can ever be in a federal system. (Especially, one might add, in a federal system where the national parties are State-based.)

On our home ground, the formula presented by privatisation does not fit with my perception of Australia's circumstances.

Sadly, I have no quarrel with the view that Australia's external environment is not only adverse, but worsening in its effect upon our interests. Yet, so far from driving government out of the market place, the realities of global interdependence — the transnational regimes that are altering the conditions under which we have traditionally traded — compel further and closer ties between the public and the private sectors in the attempt to define and defend the national interest. An old pattern is again clearly discernible in contemporary politics: cattle producers, sugar growers, tin miners — in short, all those affected by changes in international trading relationships — are urging more effective representation in foreign capitals and international organisations by Australian diplomats, as well, of course, as increased coordination between those representatives abroad and these industries at home. In this demand upon the public bureaucracy, I do not consider the cattleman to be misguided — as the privatiser might suppose him. I think he is being realistic.

The societies that are adapting best to the conditions of international interdependence are surely those in which the public and private sectors are working closely together to absorb and apply the new technologies, to channel research and development into production and sales, to provide information upon which to plan. To be sure, for government to be effective in this process may require a redirection of effort, possibly an augmentation in capacity as additional skills are acquired; but it is change, not elimination, that our external circumstances are likely to require of the public sector.

Domestically, the privatisation remedy also fails to impress me. Its agenda is scarcely the full scope of issues alive in contemporary Australian politics. But then, a political aim of the forces espousing privatisation may be precisely to trim the national agenda. If 'deregulation' means no environmental impact statements, no requirement to negotiate with traditional owners under land rights legislation, and no need to meet equal employment opportunity provisions, then conservationists, aboriginals and women can be ignored. That may be convenient for those interests opposed to their claims. Yet in a democracy our choice is not between politics and markets; rather, our choices arise in the complex world of politics and markets (Lindblom, 1977). Moreover, in our setting for these perennial

difficulties of liberal democracy, there seems to me little connection between the user-pays principle and the realities of voluntary activity so characteristic of Australian suburban and rural life — activity that accounts for much of the amenity of life in this country.

Finally, the privatisation school's diagnosis seems to me unsubstantiated. Despite the assertion of a causal connection between size of the public sector as a proportion of GNP and economic growth and efficiency (James, 1986), the link has not been established (Saunders, 1985). To a political scientist, assertions of this kind are reminiscent of those theories that ascribed a particular external policy (pacific, bellicose) to a particular type of regime (democracy, dictatorship). History confounds such ideal-typical generalisations; a more finely-grained analysis is needed before either the comparisons or the hypotheses become fruitful.

Even by the standard of public sector as a proportion of GNP, it is not clear that among the OECD countries Australia yet suffers from chronic enlargement of the organs of government (Wilenski, 1986). The most serious problems of government in Australia today seem to me to arise not from its size but from the sheer complexity of the issues with which policy must contend, the fragmentation and frustrations imposed by a federal structure, the contrary demands of an increasingly diverse society, and the vulnerabilities suffered by any relatively weak actor in a world of stronger powers.

The state in Australia may or may not be a public utility. But it is not — at least, not yet — vast. The image of Leviathan in the title of this volume is therefore inappropriate. Nevertheless, it prompts the recollection that Hobbes constructed an absolutist regime to relieve individuals from the hazards of living in the state of nature, which he depicted as a condition of unregulated competition. The social consequences of a strict application of the privatisation program risk delivering us into a division between advantaged and disadvantaged that would quickly resemble Hobbes's state of nature, while its political consequences are likely to be just that strong state, or Leviathan, that Hobbes proposed (see Thatcher, cited in Heald, 1983:322).

### **Dilemmas of Government in a Liberal Democracy**

To reject privatisation as a general strategy is not to admit complacent satisfaction with the present state of affairs. How to make government responsive. How to keep its activities consistent with its purposes. How to restore the representative element in democratic politics. How to secure, nationally and internationally, the conditions for economic prosperity. How to ensure an equitable distribution of benefits. These I consider among the compelling problems we face.

In dealing with these problems, it is likely that some of the recipes associated with privatisation will prove useful. Hugh Stretton has called attention to such a case, but I pay heed to his examples of failure also (Stretton, 1986). Privatisation may be effective as a technique; it is inadequate as a theory of government (Self, 1985).

This brings me back to the starting point of the Benthamite tradition in Australian politics. As a tradition it has ossified. Its conservative, narrowly inadequate influence in the central institutions of our polity suggests that it may be a source not so much of growth as of sterility. In the impasse it presents, it may not be surprising that a challenge as frontal, as vigorous, as methodologically confident as privatisation should have made much ground.

Yet if I reject the challenge as resting upon an inadequate account of social existence and as forcing a dichotomy between public and private that our history above all will not bear, am I condemned thereby to the barren utilitarianism that I have depicted as our national inheritance?

At this end of the 20th century it would be bizarre to espouse either Benthamism's moral psychology or its legal optimism. Nevertheless, without adopting its doctrines, it is still possible to admire its impulse towards practical reform. Benthamism was a critical philosophy whose adherents were rightly called Radicals by their 19th-century adversaries. In our present circumstances, it may be the spirit rather than the letter of our Benthamite origins that we do best to recover.

There may equally be merit in the conventional expectations of the state that are consistent with Australians' historical experience. Again at this end of the 20th century, there is much to be said for an unheroic view of the state, for a tradition more concerned with practical operation than doctrinal consistency, and for the belief that in a civilised community the public and the private are meshed together — and that the contrivance of government is to maximise the benefit of that interdependence for all those affected by it.

Are a reformist tradition and the manners of Australian democracy sufficiently robust to meet our contemporary dilemmas? As has already been noted, there is currently a defensiveness to arguments in favour of the public domain. Those making such arguments no longer have recourse to a ready dogma. Instead, they will be found, like Self, appealing to a liberal and rationalist tradition (Self, 1985:ch.8), or, like Heald, candid in their admission of the defects and difficulties that their value preferences produce (Heald, 1983:ch.14).

Today, this is the natural predicament of liberalism. It should cause neither surprise nor embarrassment. For in it we recognise the condition so well described by Judith Shklar (1984:249):

that liberalism imposes extraordinary ethical difficulties on us: to live with contradictions, unresolvable conflicts, and a balancing between public and private imperatives which are neither opposed to nor at one with each other.

To treat politics as less demanding than this would be mere pretence. For Australia, the deepest problem is probably not that our government is too big, but that as citizens we are too frail.

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# COMMENTS

*J.J. Pincus*

The subtitle of this volume — *Small Government in Practice* — makes Peter Saunders's paper a particularly appropriate one with which to open. In his paper, Saunders continued two themes that have appeared in OECD publications for about a decade, beginning possibly with OECD Study in Resource Allocation No. 2, *Public Expenditures on Education* (July 1976), and expanded and amplified in OECD Economic Studies No. 4, *The Role of the Public Sector* (Spring 1985), of which Peter Saunders is co-author. The first theme is that there has been in the last 20 years or so a growth in government spending of a remarkable speed: in 1960, general government expenditures were equal in size to one-quarter of the GNP of OECD countries on average; by the middle of the 1980s, the average government budget in OECD countries amounted to almost one-half of GNP. Twenty-five years ago, only one of over 20 OECD countries (barely) had a ratio of general government expenditures to GNP that exceeded one-third; by 1983 or 1984, only Japan (just) fell below one-third. Even Australia, clearly identified in the 1970s by the OECD as a country with low taxes and low public expenditures, has sailed past one-third. And this is the second theme — Australia in the years since WWII has been and remains a (comparatively) low tax, low spending country.

Thus many of us here at this conference, possibly unknowingly, have had the experience of living with 'Small Government', albeit with government that has been catching up to the OECD average. Yet, many Australians say they are living in a country with a big government. Are they wrong? Or lying? Do the figures on aggregate public budgets tell us what we want to know?

To begin discussing this last question, let me remark first that too small a government is a disaster in most ideologies, be they liberal (small l) or social democratic or totalitarian. Even the radical libertarian philosophers of recent years acknowledge the desirability of at least minimal public defence against external enemies, and at least minimal

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public provision of internal security of persons, property and conventions of behaviour; and most recognise the value of public redistribution (if only cynically as an insurance against civil disorder). Put more generally, for every possible government program, or for each governmental activity, at any given time and place we can conceptualise an **appropriate level**. Analysts and commentators will generally disagree about what level is appropriate, it is true, but most would agree that whatever the appropriate level of, say, defence effort in peacetime, a higher level is appropriate in wartime; alternatively, whatever the appropriate level of total public expenditure on unemployment benefits when the economy is booming along, the appropriate level is higher in recession. And so on. Therefore, even when we are confining our attention (as Peter Saunders does not) strictly to public budgets, **aggregate data** could seriously mislead. I suspect that most people would be inclined to claim that there are some things in which public activity or presence is too great, and some in which it is too small. Aggregate budget data conceal these excesses and shortfalls, and do not substitute for detailed analysis of the component parts.

Worse still, aggregate data on public expenditure bundle together what should be kept separate. Peter Saunders remarks on shifts in the composition of public spending: the relative reduction in public capital outlays (even after adjustments for 'creative accounting', e.g. lease-backs); the vast rise in cash social security outlays; and the shift away from the more traditional areas of collective goods and economic services; and he goes on to state that these compositional changes may be of greater significance than the growth in government outlays itself (p.19 above).

It is worth expanding a little on this last point, because it reveals the poverty of the aggregative conceptual framework for analysis of government (Geoff Brennan and I have covered this ground elsewhere [1983], so I can make the points briefly). The venerable twin deities of economics are the income effect (or wealth effect) and the substitution effect. Only with the aid of these we can analyse the consequences of public programs for the allocation of economic resources between various activities — e.g. work and leisure; manufacturing and mining; present consumption and future consumption — and analyse the consequences for the distribution of economic well-being among people or groups. Taxation reduces the wealth of the payer directly by taking it away and indirectly by altering the relative prices of various activities; both effects also cause some adjustments in behaviour. The receipt of a public outlay increases the wealth of the recipient, while the rules that always accompany receipt of public outlays (in kind or in cash) reduce the value of the receipt; once again both effects also cause some adjustment in behaviour. In this context, the significance of the increase in government spending on what are mostly private goods can be

grasped. The usual redistributive pattern (see Ruggles and O'Higgins, and O'Higgins and Ruggles), into which Australia seems to fit, is that the overall tax system is almost proportional in income (except at the extremes) and that government expenditures are almost lump sum. Therefore, the increase in tax-financed distribution of goods and services that lack a substantial 'public goods' component has probably tended to equalise the post-fisc distribution of consumption in Australia. Its effects on allocation are, however, much more doubtful, as is perfectly clear in the case of hospital and medical expenditures, where public outlays mostly merely displace private outlays, leaving the aggregate medical and hospital expenditures unaffected. None of this is shown by aggregate data on government budgets.

What actually can we learn from aggregate data on public expenditures? Peter Saunders correctly remarks that 'the share of outlays in GDP does not indicate the proportion of GDP produced by government, or spent by government. It does, however, indicate the proportion of productive resources that will ultimately be required to finance the activities of government, in the form of either taxes, charges or borrowings' (p.13 above). In other words, the ratio of government outlays to GDP is, roughly, the average tax rate (counting in taxes today, taxes tomorrow and taxes yesterday). Now, the comment made about the loss of information caused by aggregation of expenditures can be made about aggregation of taxes: some taxes do more harm or more good than others. Particularly notable is the heavy reliance made in Australia on a system of personal income taxation with relatively high marginal rates coming into operation in the range of earnings that includes most full-time workers, and the concomitant lack of social security taxes. It seems plausible that the Australian tax system is more costly than is indicated by cross-country comparison of average tax rates; and that the heavy reliance on an income tax with high marginal rates for the average earner has had the effect of reducing the popularity of further increases in government spending (Brennan, 1985). Thus, our public budgets are probably 'bigger' than they appear from international comparisons of ratios of expenditure to GDP.

Early in his paper, Peter Saunders warns us that it is not possible to derive a single all-encompassing measure of the size of government because various forms of government intervention are substitutes (p. 12 above). Leaving aside any dispute about the principal claim (apart from noting that the proponents of computable general equilibrium models deny the truth of the proposition about a single measure), let me concentrate on the question of substitution among government interventions and, in particular, the implication for the usefulness of aggregate budget data. The problem is a bit more serious than Peter Saunders acknowledges (although not as serious as Kotlikoff, 1984, claims: that for any given pattern of publicly-induced redistribution and

reallocation, a budget of any arbitrarily chosen proportion of GDP can in theory be devised). Peter Saunders includes discussion of two matters along with his presentation of data on aggregate public outlays and public employment. These are so-called 'tax expenditures' and regulation. On the second, I was disappointed that all we are given are data on the costs to government of business regulation, likely to be trivial in relationship to the full costs to the economy, and unlikely to be a useful indicator of the size of government regulation. On the former, tax expenditures, putting aside my own serious doubts about the whole concept, I want to note that tax expenditures, if converted to ordinary government expenditures, would have added in 1970-71 an amount equal to about 3 per cent of GDP to total government outlays (themselves otherwise 31.5 per cent of GDP) and considerably less thereafter (e.g. 2 per cent in 1985-86 when the ratio of public outlays to GDP was 43.4 per cent). These numbers — 2 or 3 per cent of GDP — are far smaller than the equivalent numbers for two aspects of the Australian public sector neglected by Peter Saunders for which the conceptual difficulties are much less than those involved in the calculation of tax expenditures. These neglected areas are import protection and cross-subsidies within public monopolies.

Australian economists have produced a series of estimates of the implicit taxes levied by government but collected by Australian producers of manufactured goods protected by barriers to imports. Some of these estimates are presented in Table 1, and they indicate that, until recent years, the hidden costs of protecting manufacturing have been as great as one-third of explicit public outlays; and that they drove the augmented ratio of outlays to GDP above 40 per cent by the early 1960s. Until the OECD does similar calculations for the other OECD countries we can only guess whether the Australian record is unusual or not. Certainly no OECD country in 1960 had a ratio of general government expenditure to GDP greater than 34 per cent (compared with my augmented Australian ratio of 41 per cent in 1961-62); and certainly Australian explicit budget subsidies to producers (both manufacturing and agricultural) have been low on OECD standards, suggesting the possibility that Australia has relied more heavily on implicit subsidies.

We can safely conclude that Australians have enjoyed a very large increase in public spending over the last 25 years. Aggregate budget data are a useful indicator of the growth in the burden of government finance in one country (like Australia) because local commentators can alert us to changes in the ways that governments are doing what they are doing, so that we are less likely to be misled by the budget data. Even so, the big reduction in implicit taxes, due to the fall in rates of import protection, has gone pretty much unremarked, although it half offset the rise in explicit taxes between 1971-72 and 1981-82. Aggregate data are dangerous, however, when they fool us into making uninformed

comparisons; when we do not read the small print telling us to 'Handle with Care'. Despite all the efforts of the OECD to put budget data onto comparable bases, I do not believe that we can yet safely say that Australians suffer comparatively small government.

Table 1  
Estimates of Implicit Taxes

	1926-27	1961-62	1971-72	1981-82
Public budget outlays as a %age of GDP	12.9*	32.1*	30.0	38.0
Producer subsidy-equivalent as a %age of GDP	3.9	8.6	9.8	5.6**
TOTAL	16.8	40.7	39.8	43.6

\* Includes some PTE outlays later excluded.

\*\* Figure is for 1982-83 and is unchanged from the figure for 1977-78.

Sources: 1929 Bridgen Enquiry; 1965 Vernon Report; various IAC publications; A Barnard, *Source Papers in Economic History*, No. 13, *Some Government Financial Data 1850-1982* (ANU, August 1985).

I'd like now to turn to Hugh Collins's paper. The 19th-century colonial socialism he refers to amounted to public provision of goods and services, mostly transport and communications. The tenor of his paper is that Australians have, for reasons of either ideology or opportunity, relied very heavily on government. This serves as a counterweight to the argument that Australia can be shown, by reference to budget size, to have a relatively small government.

I thought it was unnecessary to represent privatisation as a complete strategy for political order, and then to imply that any substantial pursuit of privatisation would lead rapidly to a reversion to a Hobbesian state of unconstrained rent-seeking (as distinct from competition). There is no need to confuse the claim that some government programs have ceased to fulfil a worthwhile function with the claim that all government services should be privatised. There is a clear difference between wanting to modify government and wanting to eliminate it altogether. The former seems to represent no threat to Australian society.

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## DISCUSSION

**Cliff Walsh (University of Adelaide):** One of the oddities of public sector accounting is the netting out of recoveries, fees and charges for government services. Do we have any idea how much these amount to? In the 1986 budget about 20 per cent of the expenditure savings consisted of relatively minor increases in charges. These can hardly have much economic impact, since the prices are already way below market levels, and the goods and services concerned are being rationed in other ways.

Another feature of public sector accounting is that the public sector is valued in terms of inputs (by factor cost), whereas the private sector is valued in terms of outputs (by market prices). This could lead to the relative size of the public sector being either overstated or understated.

**Peter Saunders:** I have no estimates of the value of government charges. On the issue of measuring the value of the public sector in terms only of inputs: At the Economic Planning Advisory Council we found that the calculated price deflator for public expenditure (which in effect relates to salaries of public employees) increased considerably faster than the private sector price level until 1980 — throughout the 1970s it was outstripping it by between 2 per cent and 3 per cent per annum. Since then the two measures have moved roughly in line with one another.

**Geoffrey Brennan (Australian National University):** Hugh Collins's utilitarian explanation of Australian dependence on the state strikes me as a diagnosis in search of a disease. If it were the case that the predominance of Benthamite utilitarianism was responsible for the size of the public sector, then one would expect big government to be a uniquely Australian phenomenon. But in fact virtually all Western democracies have experienced a similar growth in their public sectors. Whatever the impact of utilitarianism on the language of Australian politics, it surely can't be responsible for the subject under discussion.

More particularly, his argument that the deregulatory thrust lies outside the Benthamite tradition is highly dubious. I would regard the movement for deregulation in Australia as predominantly an economists' phenomenon. The influence of libertarian philosophy of the Nozickian variety has been relatively minor here. The main impulse has been a

functionalist-utilitarian one, a response to the wholly consequentialist issue of whether big government does more good than harm. So if Hugh Collins is correct about the influence of utilitarian thinking in Australia, then the push for deregulation should be more successful here than elsewhere.

**Hugh Collins:** I was of course aware that there are utilitarian elements in the case for small government. But the package of Benthamite ideas implanted into our public life as a set of assumptions is resistant to a later wave of utilitarian analysis of the kind Professor Brennan is talking about. I am impressed by the inability of that inheritance to cope with diversity. The middle ground of Australian politics has been captured by those who have used the symbols of that inherited ideology most successfully. But those symbols seem unusually hollow, empty, and sterile when confronting the dilemmas of change.

The economists may be throwing back at the Benthamites something in their own tradition that they have forgotten. In that sense, there may be in that particular approach to small government a greater opportunity to have some purchase on the predominant ideology than there is in the libertarian approach, whose philosophical premises lie wholly outside that tradition. There is a tendency in this debate to lump together sets of ideas that have distinct bases and that proceed in different directions. The economists' approach that Professor Brennan outlines should be more compatible with the language of public debate in Australia than are some other approaches to smaller government.

# **Achieving Public Objectives with Less Money**

*Patrick Minford*

**Patrick Minford** is Edward Gonner Professor of Applied Economics at the University of Liverpool, where he has been since end-1976, after spending a year as editor of the Review of the National Institute for Economics Social Research. Prior to that, he was economic adviser to H.M. Treasury's external division, and was with H.M. Treasury's Delegation in Washington, D.C., during 1973 and 1974. He has also held appointments as economic adviser with the Ministry of Overseas Development, the Ministry of Finance in Malawi and the Finance Director of Courtaulds Limited.

Patrick Minford completed his PhD at the London School of Economics in 1973, and is the author of a book on the exchange rate; of *Unemployment: Cause and Cure*, which set out a new analysis of UK unemployment; and (with David Peel) of a textbook on Rational Expectations. He has also written widely in journals on trade and the economy. His recent work has included models of the UK and of the international economy, which assume that markets are efficient in their use of information. He has also contributed actively to the macroeconomic policy debate in the UK; in 1979 he started the Liverpool Research Group in Macroeconomics, which publishes quarterly forecasts of the UK and a commentary on policy issues, both domestic and international.

# Achieving Public Objectives with Less Money

*Patrick Minford*

## I. INTRODUCTION

A bloated government sector is the root cause of inflation, because governments are impelled to use money to finance themselves sooner or later given the limits on taxation; by driving up taxes to these limits and by the direct effects of transfers on incentives, bloated government also causes unemployment and reduces growth. It is such general propositions, with wide-ranging if not universal validity, that have driven macroeconomists like myself to examine what is traditionally the preserve of paid-up microeconomists, namely the efficient allocation of economic functions between public and private sectors and within the public sector itself. My own particular concern has been the UK where these propositions certainly appear to apply with force. Controlling government expenditure has been a shared failure of all governments of whatever political hue — at least until very recently under Mrs Thatcher — and it has undermined UK economic performance generally giving rise to the 'British Disease'.

Yet it is not as if the British people had a set of preferences that sets them apart from other peoples where government spending is much lower; for example, the United States and Japan. True, the British value certain 'social' objectives, such as the general availability of basic education, health care and pensions, and income support for the least fortunate. But so do others. The question then arises: can these preferences not be satisfied more efficiently? After all, when we complain about 'bloated' government, we do so only because this excess leads to distortions or inefficiencies in the economy's operation, showing up as inflation, unemployment, and low growth, the losses from which are in principle measurable (if not so easily in practice).

Three main developments in economic thought have made a fresh approach to the issue fruitful. Rational expectations is one; it has largely removed from the pro-interventionists' armoury the excuse that

the macroeconomy suffers from 'market failure' because the participants use information inefficiently. Another is public choice theory, which has elucidated the possible effects of the incentives faced by politicians and officials; this has removed another potent weapon, the myth of the disinterested 'public servant'. The third is the 'Austrian' theory of contestable markets, which has given us the insight that monopoly as such does not prevent competition, rather it is restrictions on the potential for entry. This potential exists very widely in the private sector, possibly universally if one takes a suitably long time horizon over which the 'sunk costs' advantage of incumbent firms goes to zero; but it can be frustrated by government regulation, par excellence when the monopoly is in the public sector itself. The theory of contestable markets focuses then on the malign effects of government control on competition; it suggests that a 'private monopoly' is indeed better than a public monopoly.

What I have to say will draw heavily on these developments in assessing the inefficiencies of current ways of satisfying modern Western 'social' preferences, and in suggesting alternative ways. The alternatives are not new, but they have a 'classical' or 'conservative' ring to them. Nor indeed is the use of 'consumer surplus' analysis new in assessing the inefficiencies; that analysis of course goes back to Marshall. But the renewed confidence that we can have in these old-fashioned ideas stems from the three developments I have mentioned.

It is fortunate that the ideas have now been put into practice on a significant scale, particularly in Britain and the United States, so it is possible to talk about initial effects at least of certain elements in this 'new conservative' reform program. I shall focus on the British experience (with some sideways glances elsewhere) because I am most familiar with it and because it is most relevant since the problems in Britain were most acute.

## II. PUBLIC SECTOR INEFFICIENCY AND PRIVATE REMEDIES

There are three aspects of 'public expenditure' that require careful differentiation:

(1) Much public expenditure involves public production. The state provides the capital, the management, and hires the labour for such things as primary and secondary education, the National Health Service (NHS), and the nationalised industries. However, obviously not all public expenditure goes on publicly produced goods and services. For example our defence goods industry is entirely private; another example is the universities, which are privately owned and run though of course heavily state subsidised.

(2) Much public expenditure involves public purchase on behalf of the public to whom the goods and services are passed on at prices different from those that would have been paid had people bought the same things privately themselves. Examples of public purchase from the private sector are defence products for the armed forces, drugs and equipment for the NHS, roads and maintenance, council houses and maintenance. Where the state owns the production, the state is usually the main or only customer in its role as public purchaser; the examples of primary and secondary education and the NHS are prime ones. But in the case of nationalised industries this is not so; the private sector are the main customers. Finally, a lot of public expenditure does not involve public purchase, notably transfers such as pensions, supplementary benefits, and debt interest, which go straight into people's pockets for them to spend. These are best thought of as part of the tax (and transfer) system by which the state distributes income both within one generation and (by borrowing and deferring tax) between generations.

(3) Public expenditure invariably requires taxation, whether present or future (if borrowing is used). It is usual in discussing public expenditure theoretically to assume that this taxation takes the form of 'lump sum transfers' — i.e. a poll tax — this being the only sort of tax that causes no economic inefficiency (or 'incentive effect'). But in practice no modern government makes significant use of poll taxes, for the obvious reason that they are very 'regressive', hitting the poor as hard as the rich. Rather, governments have used expenditure taxes (such as Value-Added Tax) and income taxes (including National Insurance Fund contributions); they have also used inflation, which taxes people according to their holdings of non-indexed financial assets, how much depending on how far ahead the inflation was anticipated. Borrowing without default (either explicit or implicit via inflation) can only defer taxation, but in practice governments often prefer to use inflation as a way of easing the debt burden. Whichever of these routes is chosen as an alternative to poll taxes involves a loss of economic efficiency that deserves to be studied as part of the public expenditure debate.

I now focus on each of these aspects in turn and evaluate the efficiency dimension of each.

### **Public Production**

One can visualise in principle the state being a producer of widgets, operating alongside a lot of competing private producers (who deprive it of any monopoly power) and enjoying no subsidy (or equivalent privileges such as preferential tendering for government contracts) to its operations. But this is a very rare occurrence for the obvious reason that once the state is a producer of widgets, it becomes in the direct interest of the state, as a corporate entity consisting of managers, tax gatherers,

employees, public unions, and politicians, to maximise its returns (broadly defined to include non-monetary returns) from the activity; this it does naturally by hedging the firm around with protective devices. The most effective device is monopoly power, which applies to the vast majority of state producers. Examples are nearly all the nationalised industries, schools, and the NHS (the NHS has a monopoly of 'free' medicine, which is best treated as a different product from private medicine under present institutions).

However, this device is not always so readily available. For example, when the British government took over British Leyland (BL), it was unable to give it a monopoly of cars; the British consumer would not have stood for that. In these cases it can subsidise the producer, or it can erect a tariff (or equivalent) barrier, which is the same as simultaneously subsidising the producer and taxing the consumer by equal percentages. For BL, the government both gave a direct, overt subsidy, which continues, and installed a covert tariff barrier by sanctioning a UK cartel arrangement for cars, which enables all the UK producers to raise their UK prices. The Japanese, who might not have cooperated with the European multinationals who operated this cartel, were coerced by the government into accepting 'voluntary' quotas and, since they could not compete for extra business, were content to let their car prices rise in line. This cartel also continues, though it has come under attack and the present government has agreed in principle that it should end.

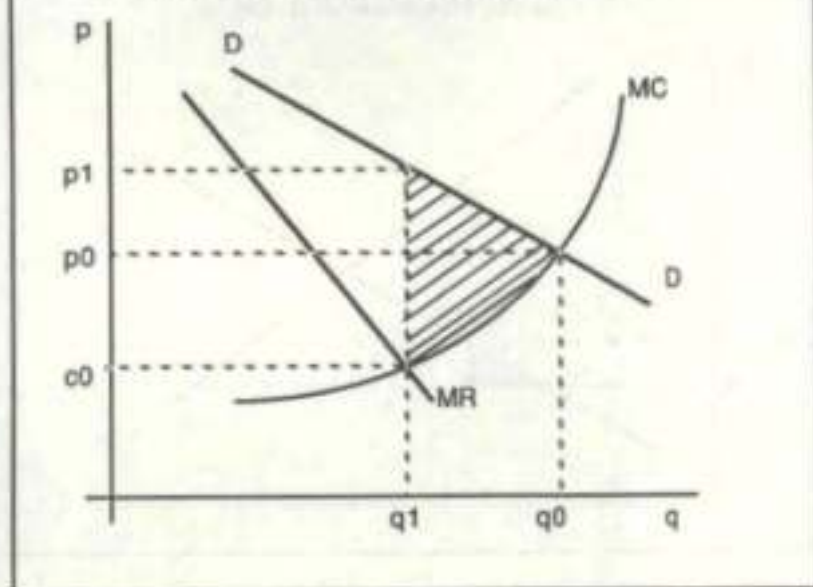
The cost to society (i.e. the residents of the UK, its 'consumers' and 'taxpayers') from such protective devices can be measured by a well-known technique developed originally by Alfred Marshall: the 'consumers' surplus' lost, i.e. the pure waste of resources due to the inefficiency fostered in production. There is nothing controversial about this method of measuring losses; all economists accept it and use it. A variety of refined measures have been developed in recent years as well as new and ingenious ways of measuring in practice. We are here interested in a rough idea of the orders of magnitude, and for this purpose we will stay with Marshall's original formulation, as further extended by Arnold Harberger of the University of Chicago (Harberger, 1964).

First monopoly power. Its cost to society is illustrated in Figure 1.

The monopolist sets marginal cost equal to marginal revenue, reduces output from  $q_0$  to  $q_1$ , raises price from  $p_0$  to  $p_1$ . The loss to society shown in the shaded area represents the difference between what people would have paid for each extra unit (over and above  $q_1$ ) and what it would cost the monopolist to provide it (i.e. his marginal cost); these differences for each extra unit are then added up to give this (the shaded) area. It turns out that an approximation to this as a proportion of the monopolist's revenues is:

$$0.5 * \text{the price elasticity of demand} * [(p_1 - c_0)/c_0]^2$$

Figure 1  
The Social Costs of Monopoly Power



For example, a monopolist who charges 30 per cent over his true marginal costs for a product whose price elasticity is 1.5 (i.e. a 1 per cent rise in price would reduce demand by 1.5 per cent) would cause a social loss of  $0.5 \cdot 1.5 \cdot (0.3)^2 = .0675$  or 6.75 per cent of the value of his operations. He is wasting this much resources as a proportion of the resources he controls.

We turn to subsidies and tariffs for public producers not protected by monopoly. The costs can be analogously calculated. Figures 2 and 3 illustrate the usual case of a good entering international trade. These can be simply explained. The subsidy and tariff rates are  $s$  and  $t$  respectively,  $\pi$  is the world price that would prevail on the domestic market for producers and consumers alike if there was no intervention. With a subsidy (Fig. 2), the price received by producers rises to  $\pi(1 + s)$ , and they move resources into the industry; the cost to society for each extra unit is the difference between the price required by the producer to cover his marginal costs (as shown by the  $SS$  curve) and the cost to society of buying the product abroad at the world price,  $\pi$ . Adding these extra costs up for the extra units involved gives the shaded area. With a tariff (Fig. 3), not only does this all happen, but also consumers pay over the world price at  $\pi(1 + t)$ ; in addition to the cost

Figure 2  
The Social Costs of Subsidies  
( $s$  = subsidy rate;  $\pi$  = world price)

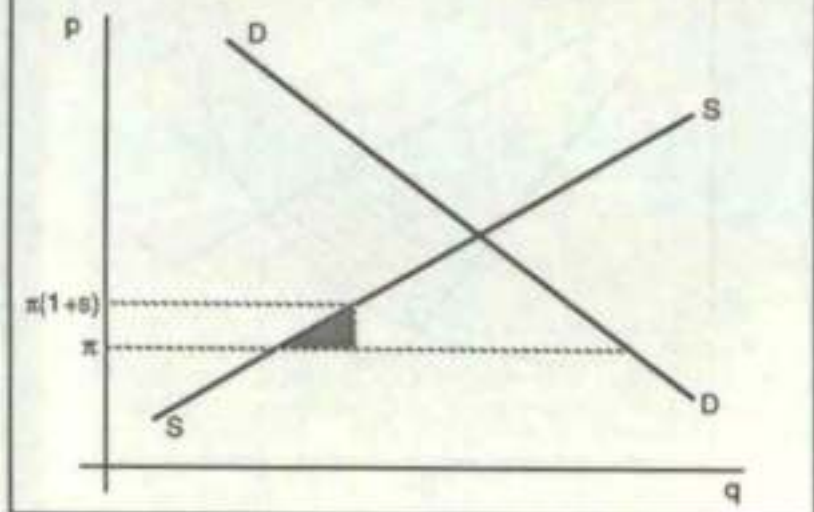
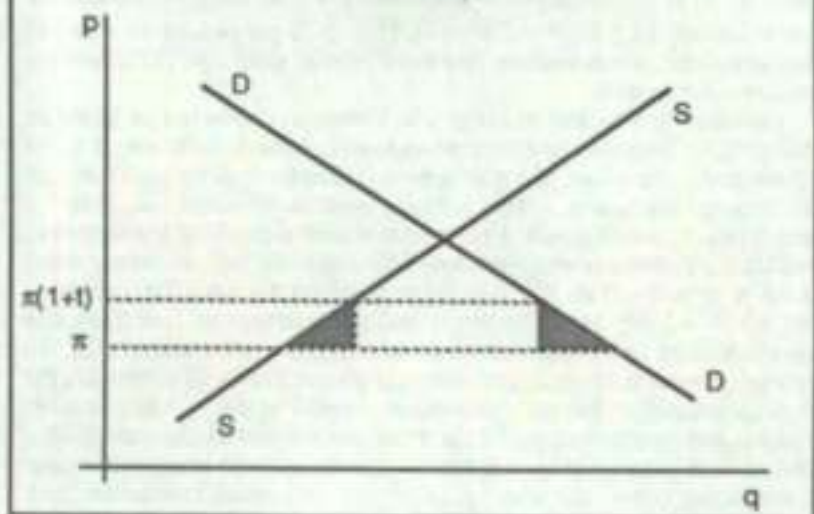


Figure 3  
The Social Costs of Tariff Protection  
( $t$  = tariff rate)



above, there is the cost to society from consumers reducing their purchases. On each unit reduction, the loss is the difference between what that unit was worth to them (i.e. what they gave up by not buying it) and the world price at which they could have obtained it.

The approximation to these sources of social loss are:

$$\text{loss due to subsidy} = 0.5 * \text{price elasticity of supply} * t^2 \\ \text{(as a proportion of production)}$$

$$\text{loss due to tariff} = 0.5 * \text{price elasticity of imports} * t^2 \\ \text{(as a proportion of imports)}$$

### **The Cure in Principle for the Waste Due to Public Production**

Long experience of political pressures shows that, if something is publicly produced, it is very hard to avoid the accretion to it of substantial monopoly power or protection. Therefore, it is utopian to think that production could remain public and yet be disciplined by competition. It follows at once that the only remedy is for production to be private and simultaneously for any residual monopoly power to be broken up, any protection to be removed — in short simultaneous privatisation and competition.

This process has no implications for the existence of the 'welfare state'. As pointed out earlier, the British defence industry is private, but we still spend on defence; in some countries (such as Argentina) the defence industry is publicly owned and the government has to spend more resources on defence (or get worse quality) to allow for the waste involved in public production. This shows that, were the total resource budget for welfare spending to be maintained, privatisation and competition would certainly increase — probably rather substantially — the value for money of that spending by cutting out the waste in production.

Once this important point is fully grasped — and it has not been in much recent debate — then both defenders and opponents of welfare spending should agree that if nothing else, privatisation and competition (from now 'privatisation' for short) should be pushed ahead. Coal, gas, electricity, railways, hospitals, schools, car producers, and all the other now publicly-owned businesses should be private production units.

The details in each industry may have to be different to allow for its technological characteristics; for example, it would make little sense to allow two telephone companies to offer a parallel set of telephone lines. A better solution is to sell a franchise for operating and maintaining a single network for a limited period, at the end of which the franchise would be resold to the best contender. This is an example of a 'natural

monopoly', of which concept much play was made when nationalisation was first introduced in Britain. The natural monopoly is one where for technological reasons (economies of scale) it is most efficient for only one firm to operate. But the example shows, as has now widely been explored in economic analysis and case studies, that competition — in the sense of 'contestability', the threat of losing business — can be effectively preserved even in these cases. Often competition can be strengthened beyond the point of the example given by separating out carefully that part of the operation that has the economies of scale from those that do not and limiting the franchise arrangement to the former. To follow the same example, the telephone lines should not be duplicated and their operation and maintenance could be franchised, while telephone services (i.e. installing and maintaining telephones, operating switching networks, sending messages) could freely compete in significant numbers on these lines.

Why then is privatisation retarded? The answer is obvious: producer pressure groups are damaged, see no chance that society will recompense them for their loss of producer privilege under privatisation, and so oppose it. For when producers have monopoly power, resources are transferred towards them at the expense of the consumer, and in the process the pure waste we have evaluated occurs because producers achieve this transfer by raising prices and so driving a wedge between the true costs of the product and its value to the consumer.

There is a paradox here. Society — i.e. consumers — could 'buy off' these producers, give them all they now get in resources as a gift from the taxpayer, and in return demand that they cease their monopoly practices; as a result society would at least recoup the pure waste we have isolated, even if consumers, other than those in these producer groups, would not get back the transfer.

But of course in practice this is impossible and dangerous. It is dangerous because it implies legitimacy in the exercise of monopoly power; in fact monopoly power is not legitimate, nor should it be since it damages society. Were society to legitimate it post facto, it would encourage it further.

It is also impossible for two reasons. First, because monopoly power is illegitimate, the producers exercise it covertly while claiming they do no such thing; their actions are 'in the public interest' because of 'special circumstances', and other such fallacious arguments. How then can society ask them, in return for a gift, to stop doing what 'they are not doing'? There is no overt basis for a trade.

Second, how could society — supposing it achieved this arrangement — police it? It is practically impossible to make reliable estimates of the true internal costs of a producer without competitors, for the producer will conceal them or pad them to avoid this. It follows that a policy of 'bribing the monopolists' is useless; but indeed the

experiences of those who have dealt with protection gangs would have confirmed this already. The bribe is taken and the screw is left as tight, or tightened if the bribe is regarded as a sign of weakness.

So producer groups will resist, the public in general will unanimously (apart from the producer minority) wish for them to be overcome, and the government has the difficult — but ultimately necessarily rewarding — task of pressing ahead with privatisation against producer obstruction. The early British difficulties with British Telecom and NHS ancillary work are classic illustrations.

We now turn to the second aspect of public expenditure, public consumption, where governments have shown much less disposition to act, and where the debate is hopelessly confused.

### **Public Consumption**

We now have to ask the question: is there any reason for the state to buy goods and services (such as medicine, doctors' services, education, defence goods, bridges and roads) on behalf of the public, using their taxes, rather than let the individual members of the public buy the same goods and services with their own untaxed money directly from the producers?

It is well known that there is one type of good or service for which public purchase can be justified under certain circumstances. This is something that, once bought and installed, can give an extra person pleasure or benefit at low or zero cost ('low' means smaller than the average cost of buying the product), including direct cost of utilisation or indirect cost of inconvenience to other users. The classic example is a park: once bought and set up, extra people can enjoy it (at least up to a certain point where congestion sets in) without imposing costs on the park budget or on other people using the park. It can therefore be argued that it pays society for the park to be used up to the point where an extra person doesn't use it simply because he has better things to do and not because he can't afford the price; in other words the park should be free because it costs society nothing for an extra person to use it. The park is said on this argument to be a 'public good' because, if it were privately bought by individuals at the average cost of park provision from a private operator, it would be underutilised; thus it is 'natural' or 'right' that society should buy it and provide it to taxpayers free.

In fact, the argument needs to be used with care, though it has applicability. Many goods have the feature that once bought and installed their marginal cost of use is at times lower than their average cost of installation; think of aeroplanes, which once bought and flying a route can carry an extra passenger for nothing. They are clearly not public goods! Even when governments buy aeroplanes, as unfortunately they do for prestige reasons mainly, they hesitate (except in some lunatic

cases) to give seats away in this manner. The reason is that for much of the time planes are full, and full prices ought to be charged; to vary prices according to the level of capacity is too complicated and hence expensive (in terms of information costs for example). Hence airlines are classed as private goods.

Furthermore, many other goods, while 'public goods' to a limited degree, are not public enough for the state to be involved in their provision. Take a squash court. This has public good qualities in the sense that extra people can use it at little cost, but it is not necessary for the state to buy it and pass it on to a group of local people. Instead, the efficient method of purchase is through a club. A club comes into existence to deal with just such a localised public good; it charges an entrance fee to a group of users willing to finance the building of a squash court, and then it levies a user cost fee for each game on the players in the club. The advantage of a private club is that it has a strong incentive to search out those who will benefit and so contribute to the fixed costs of the operations; those excluded will be those who would not contribute and so would not benefit sufficiently to cover average costs per person. Clubs will also often offer an 'occasional use' membership or guest fee for those who like to be casual users; this fee will often be set at marginal cost. The only justification for the state taking over the club activity is if there are a significant number of users unwilling to pay the entrance fee but willing to pay more than the user cost fee for an occasional game of squash. The problem with the state taking over, which has to be balanced against this potential justification, is that everyone will have to pay for a facility that only a few extra may use; this can clearly lead to underprovision, since the mass of people will have no interest in creating the facilities.

Hence the question to ask about state provision of goods with public qualities is: is the state the 'natural club' for this good? And this in effect boils down to: are the benefits of the good widely spread enough, either directly in the sense that everyone will or may use it or indirectly in the sense that everyone enjoys its availability (e.g. air/sea rescue facilities may give the public in general pleasure because they want people not to perish in sea crossings, mountaineering, etc.). This is the question, and it needs to be very carefully posed and answered by those in the public debate. A few examples of fairly obvious public goods (full status ones) are: defence, police, and economic infrastructure such as trunk roads and sewers. But we will attempt a finer discussion of the details at a later stage.

Having attempted to define public goods in principle, we now discuss the issue: what is the cost to the public if a non-public good (a 'private' good henceforth) is provided free (or at a subsidised rate) to the public, being financed by taxation?

We can in fact use exactly the same Marshall technique as we used above in measuring this waste in public production. The possibility is illustrated in Figure 4. Here we assume that the state provides all that people want of the good. The loss is the difference for each extra unit over  $q^*$ , the optimum number of units, between the cost of the service and the extra benefit to consumers as given by the  $DD$  curve. The approximate value of this as a fraction of the costs of production is

$$0.5 * e / (1 + e)$$

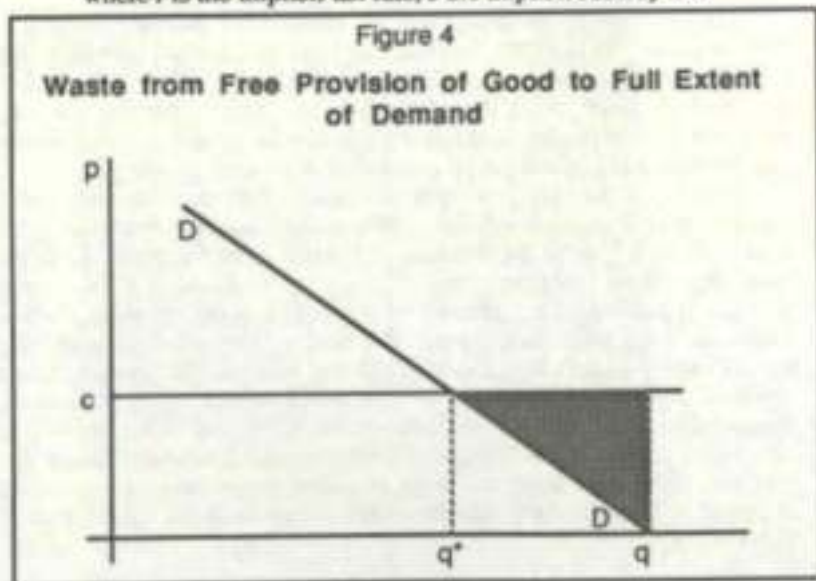
where  $e$  is the price elasticity of demand

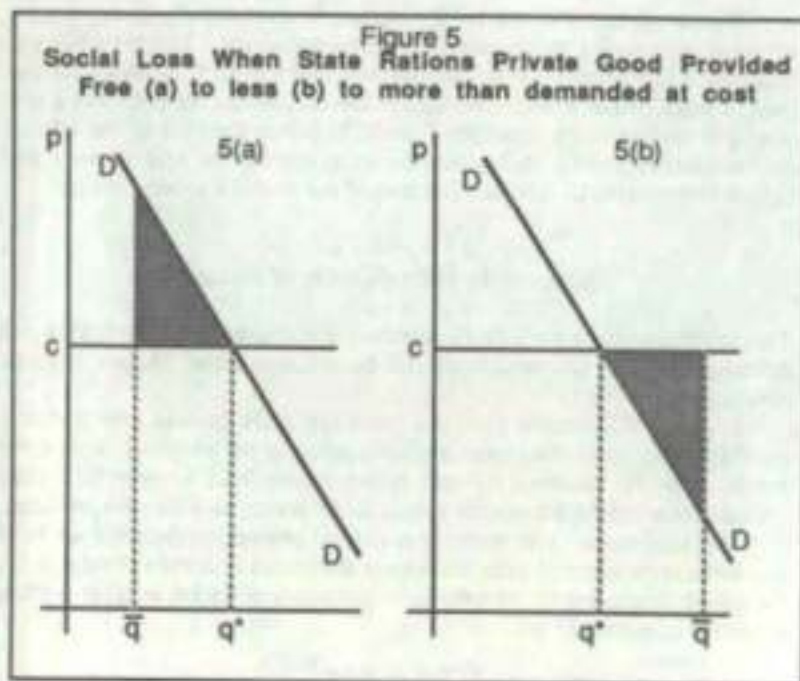
This is potentially a very large number: for example if the elasticity of demand is one, the waste would be a staggering 25 per cent of production.

It is for this reason that the state typically rations goods that it provides free. This introduces a modification of the problem: now some goods may be rationed to the point where less is provided than consumers would want at cost price; other goods may be overprovided. Figure 5 illustrates. The waste here is hard to evaluate because we have no obvious measure of how the ration translates into the subsidy or tax the public is receiving. In principle, the approximation as a proportion of public expenditure is:

$$0.5er^2 \text{ or } 0.5es^2$$

where  $r$  is the implicit tax rate,  $s$  the implicit subsidy rate





We can simplify the problem if the state allows private purchase as well as public. In this case 5(a) will not arise because the private sector will fill the gap between  $\bar{q}$  and  $q^*$  at the price of  $c$ . This in the UK is the typical case; think for example of plastic surgery or hip replacements, where the state rations below what people are prepared to pay for at cost price, and the private sector steps in at the margin.

It follows that the problems of state purchase arise with cases illustrated by Figures 4 and 5(b). Where the state 'overprovides', the cost is  $0.5(e)s^2$  or at the extreme  $0.5(e)/(1+e)$  where there is no rationing. These costs are potentially substantial because the rationing process is politically vulnerable: if the public want more expensive medicine in the NHS politicians find it hard to deny them because they are too easily cast in the role of niggardly villains. In a nutshell, the political problem of holding  $s$  to zero or a low number is in practice insuperable: free services are open-ended subsidies, in the sense that demand at a zero price is 'infinite' (compared with Exchequer resources) and politicians are under constant pressure to increase the quantity supplied. The pure waste element will tend towards the upper limit of  $0.5(e)/(1+e)$ .

This gives us a useful bracket on the costs of waste in public provision of private goods. It is unusual to find a subsidy element below 30 per cent. Supposing an elasticity of one, this would give a lower limit of 12.5 per cent and an upper limit of 25 per cent. This may well be the range of waste on the public consumption side of the NHS, for example.

We now turn to the third aspect of public expenditure, taxation.

## **Taxation**

In practice, taxes raised are wasteful because of political factors. A 'jump-sum' transfer or poll tax was from time to time practised in European colonies, but in a modern democracy it has no chance because it is the most regressive form of taxation, and in our society it is expected by the populace that the 'rich' should pay 'more', even 'most'. Hence the emergence of the 'graduated' income tax. Even expenditure taxation is not liked in many democracies because it does not bear as heavily on higher incomes as an income tax can be made to. Furthermore, a high level of protection (or safety net) may be stipulated for the poor — presumably because most people feel there is a significant chance of slipping into that category. The result of this general tendency is that marginal tax rates on labour input (i.e. personal effort) are typically high in two main areas of the income scale: high and low incomes. At the high end because the wealthy have to carry a bigger burden of tax, and at the low end because the desire to protect the incomes of the poor implies that their extra work brings little extra income.

The effects of these high marginal tax rates are well documented, less indeed at the top end of the income scale (where evidence is more elusive perhaps because it involves individuals rather than large groups) than at the bottom end in the 'poverty trap' and 'unemployment trap'.

My own research suggests that, on average across the whole economy, a 10 percentage point fall in marginal tax rates on working among the poor unemployed, whether it comes from lowering taxes on the low-paid or benefits on the unemployed, would reduce unemployment by about half a million (a rise in employment of 2 per cent).

If one accepts that a reduction in public expenditure would lower taxes on the low-paid — and even facilitate a reduction in unemployment benefits because post-tax wages that the unemployed could now obtain would be higher — then the gain to society from the expenditure reduction is swelled very substantially. Let us suppose that every 1 per cent reduction in state expenditure would permit a fall in marginal tax rates on the low-paid (because of skilful distribution of the gains across the tax structure) of 3 percentage points. Then on my calculations

employment and national output would rise by roughly 0.6 per cent. This means in effect that 60 per cent of the total cost of extra public expenditure in the UK at present levels of expenditure and taxation is a pure burden of waste on society: a staggering indictment of our public finance situation.

For what we are saying is that, because of political difficulties in raising taxation, the inefficiency of extra taxes is now 60 per cent of their yield. It follows that there is a strong absolute case for public expenditure cuts just for the sake of saving Exchequer outlays and regardless of the other, more subtle arguments we have set out above. Of course, as these bad taxes are reduced (high marginal tax rates on low and high income groups eliminated), this factor will disappear from the calculation. But at present, it must be rated as of very high importance in the debate.

### III. THE WAY AHEAD: WHERE CAN CUTS BE MADE?

Let us consider first what an 'ideal' system would look like, and consider transitional arrangements later. Too much discussion considers incremental changes from the system we have, which give little improvement and create practical difficulties, so providing an easy excuse for their rejection.

Let us enumerate our objectives:

- (1) **Efficiency in production** wherever at present the public sector is a producer.
- (2) **Optimum provision of public goods**, which should be provided only by the state.
- (3) For other goods, **efficiency in consumption** wherever the public sector is at present a consumer.
- (4) **Ensuring that the poor have good education, good health care, and are at all stages of the life cycle supported above 'subsistence' levels of income, while at the same time preserving incentives to obtain work and, once in work, to work for higher wages. Call this in short the efficient relief of poverty.**

Now let us see what can be done to achieve each of these in turn:

(1) **Productive efficiency.** The rule should be: **no public production.** All present productive facilities operated by the public sector should be privatised in a competitive set-up. If a productive

facility is a natural monopoly, then it should be operated privately after a periodic tender; the tender should be owned by the state and treated as infrastructure. This applies not merely to nationalised industries but to all other public services too, such as education, health and local authority services. The only exceptions would be on security grounds, as with police, armed forces, judges and the civil service. Even though there could be gains in efficiency from having private companies offering policing to the state as consumer, and tendering for the 'police contract' for Merseyside for say five years, it is obvious enough that the public prefers to trade any such gains in efficiency for political security and control; for suppose the private company's employees broke the law or took bribes, who would police them? Instead, the public prefers that carefully selected representatives be given the task of building up a police force with standards of public morality and service especially inculcated. What we are saying here is that public production of these goods is itself a 'public good' — i.e. the public security cannot by its nature be privately provided.

(2) **Public goods.** Apart from defence and law and order, the main group of public goods is 'infrastructure' as discussed earlier. Infrastructure is by definition capital equipment, and some people have jumped from this observation to the argument that public capital expenditure is always a good thing while public current expenditure involves waste. However, as our arguments should have made plain, this does not follow and is wrong. Some current expenditure is on public goods: defence and law and order are prime examples involving mainly current expenditure. Also, much public capital expenditure — e.g. by the nationalised industries — is not on public goods; if these industries were privatised, they might well be cut back because of unprofitability in a competitive environment.

Infrastructure then is capital equipment that the state ought to provide. How should it decide how much? The answer follows from our earlier discussion of clubs: the state is acting like a club, and while it has no difficulty in raising club fees (taxes) it must evaluate whether people's benefits from the investment exceed their costs, so that in principle they would be willing to subscribe the club fee for installing the equipment. Such 'social cost/benefit analysis' is now standard in infrastructure decisions; but political judgment also comes in and rightly so, as it would in the case of club management deciding what it could 'sell' to its members. The members are the taxpayers and their attitude to the facility and their resulting tax bill will affect their view of the politicians who made the decision.

This decision process is clearly vague and at the national level prone to error. Therefore, as far as possible groups who decide infrastructure should be set as narrowly as possible. Local roads, for example, require local, not national, decision for the beneficiaries are local. Where a road

or a bridge serves a clearly defined group and is likely to be highly utilised, a toll is possible; such projects can be 'privatised' efficiently.

This will still leave important infrastructure decisions at the national level; but, if the rest of our suggestions were adopted, then state officials would have fewer distractions and pressures from other areas wrongly in the public sector and the decisions on infrastructure would be improved. One problem in particular would disappear: that of a chronic public finance crisis as cash-hungry open-ended programs starved departments of cash for necessary infrastructure. This crisis-problem appears to have become endemic in the public sector and to have had the effect of running down infrastructure programs for purely cash reasons; this is irrational for the cuts should really fall in the areas we have been carefully setting out.

A partial list of infrastructure is:

- (National level) trunk roads
- trunk railway track
- national canals
- airline support (radar, etc.) and airport provision
- national electricity grid
- national gas grid
- national telephonic cable
- reservoir 'grid'
- (Local level) local roads ('feeder' roads)
- branch rail track
- local canals
- sewers
- local reservoirs

These and other public goods are what the state should be providing and concentrating on doing well.

(3) **Public consumption.** The main services that the state buys for the people and passes on at free or subsidised prices and that are not public goods are health and education services. The statement that these are not public goods requires some qualification. There are elements of public good in both: if your neighbour catches bubonic plague, then you and many others suffer. If someone is unable to read or understand the spoken language, he may cause others a nuisance (e.g. by disregarding public safety orders). A lack of general education impoverishes society, not just the individuals involved. But these aspects are easily handled without public purchase of health and education services for all; minimum standards of hygiene, preventive medicine (e.g. inoculation) and education can be set and subsidised directly. Inoculations for bubonic plague would naturally be 100 per cent subsidised; education vouchers would subsidise education directly.

Thus the specific public good elements are best handled by specific measures and subsidies; and we assume this in what follows.

The inefficiency that arises when the state passes on these services free or with a general subsidy was discussed above. If everyone had equal income, the answer would be clear: let each spend his own chosen amount of resources on health services and health insurance, and on education. The inefficiency would disappear (the specific public good elements being taken care of as assumed).

However, this brings us to the core of the 'welfare state' debate. Income is unequal; therefore under this system, the poor would have less access to health and education than the better off. Some go on to argue that to maintain adequate (some would say equal) access for the poor the state must buy health and education and then redistribute it. But as we have seen, state provision involves inefficiency, which imposes a cost on society as a whole.

Assuming — as we do — that one objective is to give the poor access to necessary health and education, can we resolve the apparent conflict between efficiency in consumption and this objective? The answer is yes. It is not necessary to have state purchase to achieve any given objective of access to the poor. The efficient way to proceed is to give the poor the means to buy these services, and (since these means are not intended to be diverted to other expenditure, whether food, opera or bingo) to tie these means to just these services (e.g. by education vouchers or by subsidising health insurance). Society can decide the level of support it wishes to provide the poor and then allow them and everyone else to spend this support and their own resources on buying privately provided health and education services.

This support — given society's preferences — should be means-tested. Society wishes to help the poor, not the better off; indeed it is precisely the open-ended subsidy now given to all that causes the chronic crisis in health and education.

We now examine carefully how this proposal would work in health and education.

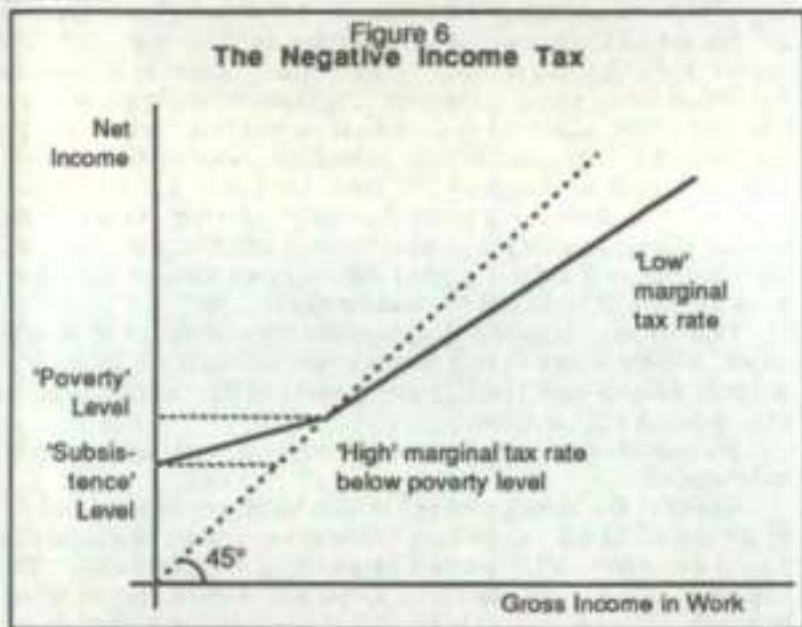
**Health:** The assumption will be that health services are paid for by the individual and that he buys full health insurance, structured in a normal way with near 100 per cent insurance for very serious bills. The concern of society is then that poor people will skimp on private health insurance. This concern could be allayed by providing a means-tested subsidy to health insurance; this subsidy could be payable on production of the health insurance certificate evidence of income. However, there is a serious problem with this method of payment: that yet another means-tested benefit is piled on top of an already complex tax/benefit system, worsening the poverty trap.

There is a better way to achieve the same effect. The concern of society is twofold: to help the poor to achieve an above subsistence

living standard but without damaging incentives, and to ensure that within their income the poor spend adequately on health. The former help is best given by a Negative Income Tax (NIT), which makes net income slip back very slowly as gross income falls towards the subsistence level; this principle is illustrated in Figure 6.

The NIT maintains the incentive to work harder and earn more, albeit with a high marginal tax rate (no more than 70 per cent). It also protects the poor in a general sort of way, i.e. via income. It is assumed to replace all means-tested benefits including rent and rate rebates, and Family Income Supplement.

Given the NIT, the assurance that the poor in receipt of NIT are spending adequately on health can be provided simply by making payment of NIT contingent on the production of a certificate of medical insurance to a specified minimum level. Such a minimum level of insurance could also be made compulsory by law, as in the wearing of seat belts.



**Primary and secondary education:** The same principles apply. Assuming that the NIT is in place, society is concerned that the poor would skimp on education for their children — which is indeed illegal, but clearly plausible. Again, the simple remedy is to make the payment of NIT also conditional on the production of receipts for school fees in respect of children below the minimum school leaving age.

**Higher education:** Higher education is quite different in that it yields a return to the graduate. There is no case for a general subsidy to higher education, since in general the skills and knowledge acquired carry a market price reflecting their social value. If society feels that particular areas of social value — e.g. the study of ancient cultures and languages — are being insufficiently studied, a particular subsidy to these areas is justified; but that is all. Students may borrow to finance their education and grants should therefore be replaced by loans; students will also no doubt work in vacations (as many do now) to help finance their studies. Universities will be forced to compete on price for students' registration, which will lower costs, increase efficiency in teaching, and cause a better allocation of resources between subjects. Students will work harder in the knowledge that their own resources are on the line.

(4) **The efficient relief of poverty over the life cycle.** We have already seen that the NIT can efficiently relieve the poverty of those in work, while carrying with it conditions on education and health standards. We have also considered the major areas of public consumption. We have ignored an important area of public expenditure: the transfer payments made to the unemployed, to state pensioners and to the disabled. We consider these now in turn.

**Unemployment benefits (including supplementary benefits paid to the unemployed):** Just as in the relief of poverty for those in work we set an NIT with a marginal tax rate of no higher than 70 per cent, already a high figure, to limit problems of incentive. So with the unemployment benefit there needs to be a ceiling on the marginal tax rate on the act of going to work at all. This could be achieved by a 70 per cent ceiling on benefits as a fraction of previous net earnings. If introduced at a time when taxes on the low-paid were being cut, as the ideas set out in this article will surely make possible, then, while the introduction of this ceiling would indeed lower benefits of those remaining unemployed, the tax cuts would raise the net wages available to them if they opt to take a job; the improved job opportunities would be welcome while the drop in benefits would increase the incentive to take advantage of these. Such a change would be highly defensible from society's viewpoint both practically and morally.

**Pensions:** Pensions are in the same category as health: a matter for personal investment but one that society is concerned that everyone should undertake and also is concerned that the poor may skimp. As with health, belonging to an adequate pension scheme could be compulsory by law, and evidence of this should also be made a precondition of receipt of NIT. The retirement age in the pension scheme should become a matter of personal choice (subject to some upper limit perhaps).

**Sickness and disability insurance:** Similar principles apply. This could be made compulsory and receipt of NIT again conditional on evidence of minimum insurance.

### **The Alternative Framework Summarised**

In sum, what we are saying is that efficiency considerations dictate radical changes in the functions accepted by the state. First, the state should withdraw from public production, except for areas such as defence, law and order, and public administration; and it should institute competition in the new private arrangements. Second, it should withdraw from all areas of public consumption except public goods; public goods include defence, etc. just listed and infrastructural capital investment. Third, it should replace public consumption in the areas listed by a 70 per cent Negative Income Tax to help the poor, conditional on their subscribing to medical and disability insurance and to a pension scheme, and paying their school fees. All 'welfare' services would then be bought by individuals in a normal manner for cash. Fourth, unemployment benefits should be subject to a 70 per cent ceiling as a fraction of previous net income.

## **IV. MRS THATCHER'S REFORM PROGRAMME: A CASE STUDY**

Mrs Thatcher has had her work cut out on many fronts besides those of long-term public expenditure reform. Most of her government's energy has been devoted to the fight against inflation and to the reduction of union power. On both these fronts, she has been fairly successful. On public expenditure the main efforts have been concentrated on the production side under the famous privatisation program. There has also been some progress in reforming the tax/benefit system. Public consumption has been so far left almost entirely alone. After some tentative investigation of voucher schemes for education, the time has been judged 'unripe' for such radical plunges, though there is now a renewal of interest that may surface in more concrete form after the next election. As for health, Mrs Thatcher felt it prudent to declare the National Health Service to be 'safe with us'. In the next two sections I look briefly at privatisation and tax/benefit reform.

### **Privatisation**

The privatisation program has captured international attention and led to emulation by other market-orientated governments (most notably and recently of course that of M. Chirac). In its own terms it has been

remarkably successful, both in raising large amounts of revenue through asset sales and in improving the efficiency of the previously nationalised sector. It has been attacked predictably from the left but also by free market economists who wanted more competition introduced with privatisation. In fact, competition has been introduced cautiously if at all, the preferred model for the large public monopolies being regulation in the private sector (as for example with British Telecom and British Gas).

This has meant that the gains in efficiency have come from liberating producers from detailed government interference — with their capital programme, borrowings, and day-to-day decision making — rather than from consumer pressure (except that of the regulator). These gains have accordingly shown up in higher profits (Amersham) and rewards for managers and workers (British Telecom). Appendix 1 gives the (rather good) record. Appendix 2 shows some more general results of privatisation and deregulation. The threat (or promise) of future privatisation has also produced profit gains in other nationalised industries such as British Airways, the National Coal Board, and British Steel; here managers and government have used the desire for privatisation as an excuse for non-interference by government in commercial management.

The regulative model has the obvious drawback that, once liberated in this way, managers will find ways of 'capturing' the regulator or blocking him by poor information, etc. As a long-term model it is therefore deficient, as has been shown by previous (mostly US) experience (see Yarrow, 1986). As a short-term model it has the attractions that (a) practical problems of transfer to the private sector are minimised because the managers are fully cooperative, (b) gains in efficiency occur rapidly and obviously (through profits), and (c) revenue from asset sales is maximised (making tax cuts possible while long-term reforms of the public sector are put in hand).

The requirement will be to effect a transition towards competition within a reasonable period of time that does not betray those who bought shares under the current model. With British Telecom, the growth of Mercury and developments in technology will act as an opportunity; indeed it is hard to see how competition can fail ultimately to be intense in the telecommunications area as alternative message-delivering systems emerge. With British Gas, the transition will have to involve divestiture of showrooms, possibly break-up into regional firms and the group operated under franchise, with coal and electricity being freely competitive (no import quota on coal, etc.). And so on; there are ways in each case. But it is reasonable to argue that without the short-term model actually used no step at all would have been possible, in a new and politically treacherous area.

## The Tax/Benefit System

The system the Conservatives inherited was one in which marginal tax rates (obviously the key concept from the viewpoint of incentives) were very high for two main groups; those on high incomes and those on low incomes. The former faced high personal tax rates rising to 83 per cent (and to 98 per cent on 'unearned' income, i.e. that generated by previous efforts, either their own or their ancestors'). The latter faced implicit rates of up to 100 per cent, or more on (a) the decision to work rather than to remain unemployed (the 'unemployment trap'), and (b) if in work, to work for more pay (the 'poverty trap'). The rates became so high because to the explicit marginal tax rate had to be added the withdrawal rate of benefit (for unemployment or for being a low-income worker).

In response the government has acted cautiously, reducing the top rate of personal tax to 60 per cent and abolishing the differential rate on unearned income. This remains an exceptionally high rate, and the yield of the higher personal tax rates is trivial (around £2.0 billion) assuming no supply responses or evasion. On the other hand, experience indicates that abolishing the 80 per cent/98 per cent gives a 'negative' yield; this is implied by recent US experience of cutting the top rate to 50 per cent, after which revenue rose strongly.

For low incomes, the government has instituted a recent reform of the benefit system, has cut the standard rate of tax to 29 per cent, has raised tax thresholds since 1979 by 21 per cent in real terms, and has cut employers' National Insurance contributions to 5 per cent from 9 per cent. The benefit reform brings the top marginal rate on working for more pay down to around 96 per cent, but at the cost of extending this rate over a larger section of the income scale; it does so by using an idea suggested in Minford et al. (1983) of relating in-work benefits to net rather than gross income. So the 'poverty trap' has been improved but high marginal tax rates remain over a wide range of low incomes. As for the decision to work, little improvement was made; benefits for the unemployed were not cut except for young workers and the 'unemployment trap' was hardly touched. In an earlier decision, the earnings-related benefit (lasting for six months only) was eliminated from the beginning of 1982; but this affected a minority of the unemployed (under 20 per cent), all of them short-term unemployed whose 'search time' only would have been affected.

High unemployment in Britain is coming from those unemployed for more than six months; for such people the system of indefinite support and living standards above the poverty line has been left untouched. There is more than a suspicion that many of the long-term unemployed are working in the black economy and have little interest in rejoining the white economy; much necessarily indirect evidence (e.g.

Matthews and Rastogi, 1985) supports the view, while a recent Department of Employment survey estimated that 1 million of the unemployed were not seriously interested in finding work.

Reforms seriously addressing high marginal tax rates appear to await a change in the climate of both intellectual and popular opinion. Intellectual opinion has shifted somewhat towards acknowledging the futility of high marginal rates; hence the cautious moves to cut top rates have been accepted. Popular opinion still on balance appears to be impressed with the idea that the 'rich' should pay 'more' (which of course they do anyway) and that the unemployed have suffered misfortune and therefore deserve unlimited support. However, shifts in this opinion too have been perceptible, particularly after the passing of the US tax reforms lowering the top marginal rate to 33 per cent.

Another area of progress has been corporate tax, where by reducing depreciation allowances (far larger than the true depreciation and so a subsidy) the tax rate has been cut to 35 per cent. Similar progress both on VAT, where the idea of a large extension of the base was floated by the Treasury enabling a cut in the rate (or in personal tax rates), and on the reduction of tax relief for 'privileged' forms of saving, such as housing, pensions and endowment insurance, was very largely frustrated by special interest lobbying; only the endowment insurance tax relief was ultimately abolished.

The tax and benefit system is an area where important steps have been taken but significant reforms are still awaited.

## V. CONCLUSION

I began by speaking about bloated government. It should now be clear in what precisely that bloated condition consists: it is the absence of competitive pressures on public producers, the absence of signals from consumers, and the distortions of private choice created by the tax/transfer system. It is *not* in the preferences themselves that public expenditure is trying to satisfy; of course appropriateness of preferences can be argued over, but that is not an argument entered into here and in a democracy there are ways of settling what are the relevant preferences (which I have implicitly assumed were known and coincide roughly with the objectives of current spending arrangements). The remedy consists not in cutting health expenditure by, for example, attempting to persuade people they don't want more health care (which they clearly do); but rather in reorganising its provision through privatisation, its consumption by making the ultimate consumer pay, and its financing by helping those who cannot afford socially determined 'necessities' such as basic health care, directly through income support programs. Marginal tax rates can then be cut by limiting government expenditure to public goods only.

Looking back on why the British got into such a mess, I am reasonably clear that it was an intellectual confusion. Influenced by socialist economists such as Laski to believe that incentives were unimportant, those in power thought the planning methods of the war machine could be harnessed to solve peacetime problems, especially 'social' problems. Four decades of research and experience have revealed the confusion; but implementing the remedies is a slow and painful process.

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*Miford: Achieving Public Objectives with Less Money*

**Appendix 1**  
**Market Results of State Sell-Offs in Britain**  
 (as of 17/10/86; Source: *Investors Chronicle*)

Company	Issue date and price	Price change since (%)	Relative to market (%)	Change in 1st month (%)	Relative to market (%)	What happened
<b>British Petroleum</b> Oil major	November 1975 bond @ 30p	-38	-43	3	2	30% oversubscribed even though shares were trading below offer price when first issued. But soon we had a big because of the attraction of being able to buy in volume without paying duty in connection with a swap payment of only 10p.
	September 1983 tender @ 40p, strike price 42p	+62	-8	+1	+9	A tender which worked - oversubscribed 1.3 times at the striking price. Several institutions were left empty handed, though good measures could easily apply 'if striking price'.
<b>British Aerospace</b> Aircraft manufacturer and defence contractor	February 1981 bond @ 10p	-20	-17	-8	-15	3/4 times oversubscribed. Went to unexpectedly large 7p premium on first day.
	May 1983 bond @ 27p	-22	-2	3	1	1/2 times oversubscribed and went to 10% premium on first trading day. Only 24% available to general public, rest propped up with institutions.
<b>Cable &amp; Wireless</b> International telecommunications contractor	November 1981 bond @ 19p	-42	-18	+10	+16	1/2 times oversubscribed. Shares went to 2p premium on first day, a day when the market fell.
	December 1983 tender @ 27p, strike price 27p	+112	+28	+2	+1	Only 70% subscribed. A big flop. Party paid shares went 7% on first trading day. Institutions decided they could pick up shares more cheaply via their underwriting commitments than by tendering.
	December 1985 bond @ 50p	8	-14	-2	-2	Oversubscribed twice. At £500, the largest share issue after BT.
<b>Ascom International</b> Manufacturer of electronic equipment	February 1982 bond @ 14p	-10	-21	-20	-27	2/3 times oversubscribed. Although only a 10% issue the weight of money chasing after it created a mini crisis in the money markets.
<b>British</b> Oil & gas explorer and producer	November 1982 tender @ 21p, strike price 27p	-44	-27	-8	-10	Only 30% subscribed. Monumental flop. 10p party paid shares closed at 8p on first trading day. Shareholders warned of all price collapse just before offer closed.
	August 1985 bond @ 80p	-21	-42	+10	+11	1/2 times oversubscribed. Priced very generously after first details. 20% of issue priced almost 40% propped up with UK institutions.
<b>Associated British Ports</b> Port operator	February 1982 bond @ 11p	-60	-108	-29	-27	2/3 times oversubscribed, even though it was a struggle to get it underwritten in large sell, coming late after British. But the undermarket was very strong in the run-up to the deadline and it was thought to have been priced cheaply to get a quick subscription rate.
	April 1984 tender @ 20p, strike price 25p	-10	+42	-2	2	A tender which worked - a little oversubscribed at the striking price. Issued just after good 100p profits announcement.
<b>Emergent Oil</b> Oil & gas explorer and producer	July 1984 tender @ 90p, strike price 10p	-20	-54	-2	8	Only 67% subscribed, of which 112 accounted for 30%. Issue was a disaster even though it was priced at the generous rate. But both oil prices and the stockmarket as a whole collapsed just before the issue.
<b>Jaguar</b> Luxury car manufacturer	August 1984 bond @ 30p	+21	+27	-10	+8	4 times oversubscribed. But money went disappointed because the shares only went to a 7p premium on first trading day.
<b>British Telecom</b> Public telephone network operator	December 1984 bond @ 13p	+27	-1	+46	-27	2 times oversubscribed. 47% propped up with British institutions, 34% with foreign investors, 20% left for general public.
<b>Average for all issues</b>		+18		+10	+9	
<b>Average for first issues</b>		+17		+10	+9	

**Appendix 2**  
**Some Effects of Privatisation and Deregulation in Britain**

(a) Privatisation

<i>Company</i>	<i>Performance since privatisation/ deregulation (Source: Financial Times)</i>
British Aerospace	Sales at record levels; orders doubled.
Cable and Wireless	Pre-tax profits more than doubled.
Amersham International	Turnover up 20%; pre-tax profits up 22%.
National Freight Corp.	£8.5m profits 1983-4; previous year only broke even.
Britoil	Post-tax profits up 35% in 1983.
Assoc. British Ports	Profits up from £1.5m to £6.8m in first half year following privatisation.

*Contracting out (Sources: Public Service Review and press reports)*

(i) NHS ancillary service:	Savings to District Health Authority estimated at £9.4m a year, including:
	<i>Savings £p.a.</i>
	Medway 357 000
	N.W. Surrey 210 000
	Huntingdon 200 000
	E. Surrey 150 000
	Redbridge 143 000

(ii) Local Authority services:	Savings to local authorities estimated at £15m a year including:
	<i>Savings £p.a.</i>
	Wandsworth B.C. 2 600 000
	Merton B.C. 1 800 000
	Wirral B.C. 1 400 000
	Ealing B.C. 1 300 000
	Kent B.C. 1 100 000
	Cambridgeshire C.C. 700 000
	Dudley B.C. 600 000
	Southend B.C. 600 000
	Eastbourne B.C. 500 000
	Milton Keynes B.C. 488 000

(Estimated percentage savings on contracted out: about 25%)

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**Appendix 2**  
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(b) Deregulation (Source: *Press reports*)

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Transport Act (1980)	Between 1980 and 1983 fares on long-distance bus services fell on average by 40% in real terms. Seven hundred new services introduced.
Hereford bus experiment	The trial deregulation of bus services in Hereford resulted in lower fares on the most popular routes and more frequent buses for suburban commuters. Subsidies fell by a third.
Oil and Gas Act 1982	Since the Act, 70 wells have been drilled in the Southern Basin of the North Sea (to July 1984), compared with only 8 in the previous 3 years.
Health and Social Security Act (1984)	The ending of the monopoly in the dispensing and selling of spectacles has resulted in cut-price glasses being available in Woolworths, and more competitive pricing in many opticians.

# **Reducing Public Sector Spending in Australia: Strategies and Options**

*Cliff Walsh*

**Cliff Walsh** is Professor of Economics at the University of Adelaide. This paper was written while he was spending a period of study leave as Visiting Fellow in the Centre for Research on Federal Financial Relations, Australian National University, and draws on work previously done while he was Visiting Professorial Fellow, Centre of Policy Studies, Monash University. This work is being further developed under the auspices of the business community sponsored National Priorities Project, which is conducting research into spending and taxation reform options for the Australian public sector.

# Reducing Public Sector Spending in Australia: Strategies and Options

*Cliff Walsh*

## I. INTRODUCTION

Following a long post-war period in which liberal-interventionist attitudes towards government held a firm grip on the Western democracies, there has been a fairly strong growth of opinion rejecting those earlier attitudes. This strand of opinion, which recognises more clearly that political failure may often be as bad as and sometimes worse than market failure, certainly holds considerable sway at the intellectual level and has found some influence at the political level, even among ostensibly social democratic parties: during the 1984 election campaign, when balance of payment crises were far from everyone's mind, Prime Minister Hawke was effectively obliged to make his so-called Trilogy commitment, which included a commitment to restrain spending growth.

Nonetheless, it would have to be said that the notion that we might be able to cut back substantially the size of public sector spending has not gained much ground in practice. The strongest commitment on offer (that by the Federal Opposition) is to restrain spending growth to zero real increases over its first term of office.

There is an interesting — and confusing — contrast here with attitudes towards taxation. Tax reform has been the central item on the political agenda for several years. I do not intend to get side-tracked into a discussion of the worth of what has been achieved. Rather, I simply want to make the point that it was argued that reform was necessary because the tax system had become unfair and excessively burdensome. While it is true that reform of the tax structure can reduce the 'burden' — the excess burden associated with non-neutrality in the tax structure — of raising a given level of revenue, in the end it is the level of government spending that really determines the burden of taxation.

While some argued at the time that the Tax Summit was focusing on only part — and possibly the wrong part — of the problem, revenue neutrality or revenue equivalence was imposed as the framework within which reform was to be considered. Not only did this fail to give due recognition to where the burden of taxation came from, it limited greatly the scope for achieving tax reform because redistributing the same total tax collection intensifies resistance among the inevitable losers in absolute terms. Equally importantly, it put the whole discussion onto a basis in which potentially desirable reform — broadening the tax base — could be reasonably resisted on the grounds that it increased the potential for expanding future total revenue collections and hence total spending.

In my view, in practical political terms (if not necessarily in pure logic) reducing the burden of public spending must go hand in hand with genuine tax reform: the tax cuts made possible by reduced spending would provide both the sweetener for those who fear they might lose long-established (if sometimes undeserved) benefits and the opportunity to more successfully pursue structural changes in the tax system. Of course, spending might nonetheless be expected subsequently to rise again. I will briefly discuss the question of imposing control mechanisms, but this matter is more thoroughly examined by others in this volume.

The central purpose of this paper is to attempt to identify ways in which public spending might be reduced. Since it is intended to be an Australian companion paper to Patrick Minford's contribution to this volume, I have attempted to go some way towards presenting my arguments in ways similar to those of his earlier work on this subject (see, in particular, Minford, 1984), without being in any way constrained by his directions and conclusions.

In Section II, I consider whether, and in what sense, it might be said that public spending ought to be reduced. In Section III, I turn to consider the nature of public sector spending and the principles (with illustrative examples of their implications) against which public sector activity should be tested if we are serious about attaining our public objectives at least cost to society. In Section IV, I draw out some of the implications of this discussion for potential spending cuts, briefly consider the 1986 Budget savings exercise in this light, and return to the question of introducing control mechanisms to help sustain reductions in spending, once achieved. Section V offers concluding remarks.

I do not claim to offer an exhaustive treatment of the issues. Indeed, in some respects I have gone less far in identifying specific cuts than many pre-Budget 'hit lists'. My purpose, however, has been to re-set the agenda, to focus on the big issues in a way that is essential if real progress is to be made in cutting back on spending by the public

sector. Until the major principles are clearly accepted, the chances of fundamental reform are slight.

## II. TOO BIG OR NOT TOO BIG: IS THAT THE QUESTION?

To say, as I have so far, that problems of political failure and prospects for a spending cuts/tax reform package suggest the possibility of reducing public spending is clearly insufficient to establish an unquestionable case for its reduction.

There are at least four particular contexts or senses in which it might be argued that public sector spending is 'too big'. One context, largely reflecting macroeconomic principles, would be that a cut in public spending is essential to restore 'balance' in the economy, or in economic policy settings, in a time of economic stress.<sup>1</sup> The 'cuts' in spending — against forward estimates of expenditure and, if they stick, as a ratio to gross domestic product (GDP) — announced in the Commonwealth Budget for 1986–87, and similar exercises of 'restraint' announced by State governments, had been sought by many financial market operators, analysts and commentators and explained by the government in essentially these terms. Importantly, however, there is no suggestion in this line of argument *per se* that the cuts need to be other than temporary, although in current circumstances the argument for a structural reduction in the size of the public sector certainly can be made as part of the general case for shifting resources from the non-traded to the traded goods sector. The fact that this strategy has been implemented and that government and opposition alike have at least temporarily made commitments to longer-period restraint may be helpful in giving impetus to other lines of argument about the size of spending.

A second sense in which it is often argued that public sector spending should be cut would be that economic growth is being unduly retarded by the size of government spending. Typically, although they often start with generalisations about governments using resources and crowding out the 'more productive' private sector, these arguments

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<sup>1</sup> In principle, of course, if and where Keynesian-type principles are applied to demand management, tax increases of appropriate magnitude might do just as well; and, indeed, on grounds of efficiency in the public sector might be much preferred. Although tax increases were used in the 1986–87 Commonwealth Budget, the particular economic circumstances we face arguably do necessitate spending cuts as part of the structural adjustments, and might have done so even if prior to the economic crisis the public sector could have been said to be efficient in its size and activities.

usually rapidly switch to discussions about the effects of public sector borrowing on interest rates or the effects of the tax system on incentives. However, putting aside (nevertheless serious) questions about deficit financing and the structure of taxation, this argument (like the first) must eventually come down to a view that government is using more resources than can be justified by reference to more general issues of economic efficiency and distributive justice.

The other senses in which we might talk about the need to cut spending — about public sector spending being too big — essentially stand alone, though ultimately the two arguments stated above must be related to them. They involve, on the one hand, the view that public sector spending is higher than it need be to secure the objectives that underlie the spending programs we have, and on the other hand, the view that many of the objectives and/or the spending programs that go with them are entirely misplaced and that the public sector is doing things and spending on activities that it ought not to be doing and spending on.

In practice, these two views have rather blurred boundaries, though in the parlance often applied to analysis of such issues a distinction is drawn between the former as involving **efficiency and effectiveness** (or value-for-money) analysis and the latter as **strategic policy analysis**. (For an interesting discussion of the distinctions between these types of analysis, and the problems of potential partisanship, see two reports by the House of Representatives Standing Committee on Expenditure, 1977, 1979.) Equally importantly, neither implies in itself that public spending is too big in aggregate. Conceivably, resources freed by better running and targeting program expenditures or by cutting existing programs could be redirected to new or inadequately met public sector objectives. Logically, of course, one would have to explain why public sector decision-making processes might lead to unbalanced spending patterns and conceivably to underexpansion of the public sector overall, despite overexpansion in some areas. A rationalisation of such possibilities would not be difficult to construct, and though it draws me away from the central purpose of my analysis, some observations on the sorts of arguments that have been advanced about the forces at work in determining the size of the public sector in democratic systems would seem worthwhile.

### **How Big Is Public Sector Spending?**

Although it is something of a digression, I might begin by pointing out that we do not know how big public sector spending is, nor what it is that public sector outlays, as usually measured, really represent (see Peter Saunders's paper in this volume). For example, direct charges, recoveries of expenditure and sales of assets are in general netted out in reporting 'public sector outlays', so what we see reported is not gross

outlays but rather the part of outlays that is left to be financed principally from taxation revenue and borrowing (plus some non-taxation revenue in the form of interest, dividends, rent and royalties). There are also a whole raft of tax concessions that have an effect equivalent to providing their beneficiaries with a subsidy (and hence they are often referred to as 'tax expenditures') but that reduce both outlays and tax receipts relative to the alternative of using explicit subsidies to deliver the benefits (see, *inter alia*, the House of Representatives Expenditure Committee Report, 1982, and references therein).

For these and other reasons we need to treat public sector outlays, as reported, with caution as measures of spending. First, even setting aside the problems alluded to above, we need to exercise caution in interpreting statements like 'In 1985-86, total public sector outlays were 43.4 per cent of GDP', for obvious but often forgotten reasons. Only a little over half of the outlays (as measured) that are being expressed as a ratio to GDP actually represented real resource use by the public sector — i.e. net current and capital expenditure on goods and services (salaries, administrative expenses, leases or purchases of assets and equipment, etc.). The remainder of these outlays are transfer payments to individuals and to private sector organisations (personal benefit payments, interest payments, subsidies and grants to enterprises, etc.) and net advances to the private sector (loans to organisations), which, while they do affect the pattern and level of activity, do not in themselves use up resources.

Second (and again ignoring the convention of presenting only net figures), even in relation to the resource-using activities of the public sector, unlike putting a value on the private sector output of goods and services (output at market price, or at factor cost plus or minus profit), public sector services are valued at input or factor cost, essentially because market prices usually do not exist. However, public sector costs (and hence outlays) will tend to overvalue publicly provided services where they are provided below cost or more generally overprovided relative to what would be efficient, and vice-versa where services are underprovided or charged at above cost.<sup>2</sup>

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<sup>2</sup> And incidentally that public sector cost would be larger than the subsidy or tax required to achieve the same effects on consumption levels with private sector 'production' of the service, even setting aside the possibility of costs being lower with private sector production. I use the phrase 'tend to' in the sentence in the text because in the case of increasing (decreasing) average costs it is possible to have overexpansion (underexpansion) of output and have costs undervalue (overvalue) the service. Further complications apply where non-price rationing is applied.

Where these and other conventions leave us in seeking a 'truer' picture of the magnitude of public sector spending is not clear. If, as is often argued, the public sector tends to overexpand activities and typically sets charges below costs, this would offset some of the effects leading to understatement of true total spending (netting out and tax expenditures), though it is unlikely in my view that this would be enough to totally offset those effects. And where underexpansion of activity is concerned, the other sources of conservatism in public sector accounting conventions would be compounded.

Be that as it may, this brief digression leads me to a few observations pertinent to the general subject of this paper. For one thing, it is evident that some steps that might be regarded as desirable in order that public sector decision making is improved, such as converting tax concessions into explicit subsidies (which might be less easily sustained for being made explicit) actually would cause public spending, as measured, to rise.

For another, as measured and publicly reported, public spending would be reduced in a way that does not genuinely reflect the consequent real reduction of public sector resource use, by increasing direct charges, recoveries and/or disposals of assets 'spare to current requirements'. I am not suggesting that these are undesirable things to do in themselves — quite the contrary in fact. But, though it might be argued that the convention of netting out such charges might encourage more widespread use of more appropriate user-pays principles, I am saying that their true impact on resource utilisation should be accurately reflected as they arise (e.g. by restraining future growth in demand for the service concerned).

The general point to flow from this is simply that securing genuine action to restrain public sector spending and resource use would be sometimes better encouraged, and certainly would be more accurately recorded, if we started from a point where the published data on public spending more accurately — more consistently with private sector spending — reflected total spending, including the subsidy equivalent of tax concessions and so on. I am not suggesting that this would be easily achieved in all respects, nor that it would act invariably to induce better policy decisions in the world of real politics; but somewhat rough measures of what is relevant are surely to be preferred to an accurate measure of what is not.

To return, however, to the thread of my earlier argument, whatever is the true extent of public sector spending, are there a priori reasons for expecting public spending in aggregate and/or in some areas of activity to be subject to influences that lead to over- or underexpansion?

### Over- or Underexpansion?

In one sense, the view that reviews of efficiency and effectiveness and of policy in the public sector would reveal savings is quite unremarkable. In the private sector, the fact that, for example, firms hire the services of management consultants and the like and conduct internal reviews indicates that they expect a return in the form of net resource savings; and, of course, the public sector uses similar internal and external control mechanisms for similar reasons. Indeed, some of the rules that spending departments and statutory authorities are required to operate under, and the scrutiny that is associated with them (e.g. in the requirements of the Audit Act and Finance Regulations and in the activities of the Auditor-General) imply tougher accountability controls than in the private sector. The question, then, is really: Are there nonetheless reasons for believing that substantial inefficiencies can exist and persist in public sector spending, and if so, on balance are they likely to result in too much or too little public sector spending?

There are certainly enough examples commonly bandied about of public sector inefficiency to convince almost anyone that with enough political will — or skill — substantial reductions in public sector spending might be possible without giving away anything of the central role and the principal objectives ascribed to the public sector in democratic, market-oriented societies. In this sense, it might be suggested that we just get on with finding the savings and put aside the question of how this relates to questions of the desirable size of the public sector and tendencies towards over- or underexpansion of activity. I disagree for several reasons.

First, we want to know about 'tendencies' because we want to design mechanisms to overcome, reverse or limit them. Thus, if it is the case that the public sector has an inexorable tendency to overextend the range and level of activities, just cutting expenditure over a year or two treats the symptoms but not the disease. The search for control mechanisms that restrain spending in semi-automatic ways, or that keep pressure on the decision-makers to hold the spending line, may be an equally important activity.

Second, we want to know about 'tendencies' because it is in understanding and evaluating them that we get to know better the nature of the political problems that are likely to face the would-be reformer of public spending and perhaps begin to identify the nature of strategies that will make possible the spending cuts that basic principles or simply common observation suggest to be necessary or desirable.

Having said all that, I nonetheless intend to be brief and sketchy because other papers consider some of these issues in more detail and because I can develop more of the argument in considering principles, strategies and options for evaluating particular areas of public spending.

It certainly seems to be the case — and, in effect, explicitly so in countries that have written constitutions — that people have judged there to be a significant risk that the governments they elect will behave in ways at variance with the 'will of the people'; or perhaps I should say that they recognise a significant risk that the 'will of the people' as exerted through the political system sometimes will be at variance with their own best interests, somehow defined.

Political scientists' discussions of the checks and balances created explicitly by constitutions or implicitly by conventions suggest limits to the extent to which exploitation, inefficiency and inequity can be pushed through the political mechanism; indeed, if they did not limit such exploitation we should expect to find the social consensus supporting the existing institutional arrangements under severe threat. Nonetheless, within those bounds a great deal of undesirable activity is possible, and the recent work of Brennan and Buchanan (1980, 1985) points to ways in which we might further constrain the excesses of sometimes exploitative governments.

Among those who have attempted to model the political process and to evaluate its likely performance in supplying public goods and services, there has not been complete unanimity about the likely effects of political processes on the size of the public sector. Tony Downs (1957, 1959-60), in his path-breaking analysis of competition for political power between vote-seeking parties, inclines to the view that the public sector may be *underexpanded* in democracies. The crux of his argument appears to be that voters will tend to be (rationally) underinformed about the benefits of public sector policies and services. Because they know that their votes and other political signals are unlikely to be decisive, it simply doesn't pay them to fully evaluate what parties have to offer. This point is not unrelated to the often-repeated assertion of Kenneth Galbraith that high pressure advertising of private goods leads voters to relatively undervalue public sector output.

However, it is not at all clear, as a matter of logic, that the characteristic features of the voting mechanism will lead political parties to undersupply in aggregate. Indeed, much of Downs's analysis is designed to illustrate that redistribution to electorally decisive groups is likely to dominate over the search for efficient provision of public goods, and that much of this redistribution is likely to occur through decisions about the supply of public sector services that have particular value to the decisive groups. At least some public sector services are thus likely to be oversupplied, though to be sure others might be undersupplied. The subsequent work of Buchanan and Tullock (1962), focusing more sharply on majority voting models, indeed strongly suggests a presumption towards general overexpansion, essentially because decisive groups (the composition of which will tend to vary in different contexts) ignore the costs they impose on others in securing

either special benefits at general expense or general benefits financed from sources that weigh more heavily on minority groups. And the later development of a literature on private interest theories of public sector intervention and regulation emphasises yet again the important role of redistribution to decisive groups — who can supply votes or more generally political resources to political parties — in shaping public policy (Stigler's seminal 1971 article remains the most compelling statement of the basic arguments; for a particular application of this line of reasoning to tax matters, see Walsh, 1984, 1986). In fact, this strand of the literature serves to emphasise how political processes may lead not only to overexpansion of the budget but also to overexpansion of regulatory intervention, and to the deliberate introduction of inefficiencies in the interests of securing income transfers to politically powerful groups — transfers that typically will have nothing to do with equity or justice as we normally interpret those terms.<sup>3</sup>

The tendency towards inefficiency and overexpansion within constraints imposed by the political process is further supported by the literature incorporating bureaucracy into the picture (see, in particular, Niskanen, 1971). Although acknowledging that public and private sector bureaucracies may be sociologically similar, with essentially identical motivations at play, that literature emphasises the different constraints that apply in the public sector compared with the private sector. Public sector bureaucrats, like their private sector counterparts, can be expected to seek prestige, power, income and so on, and are likely to obtain these through extending the resources they control. With control over vast quantities of information, including often near monopoly knowledge of the costs of producing public sector services, they are likely to be able to expand their budgets beyond the socially efficient levels and/or to operate at levels of production cost higher than the minimum necessary. While control devices (reviews, program budgeting, finance departments, etc.) will be introduced by politicians to avoid excessive exploitation of monopoly power by the bureaucracy, these will at best only modify, not eliminate, the tendency towards overexpansion and/or excess costs (waste).

Taken together, considerations such as these suggest that the political mechanism will tend to produce outcomes that do not involve efficient levels of service, or the degree of equity or justice that we desire. Indeed, in general we can expect overexpansion of public sector activity, including the provision of activities for which there is no

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<sup>3</sup> For example, transfers to shareholders and workers in the textiles, clothing and footwear, and motor vehicles industries, to doctors, airline pilots and taxi-drivers, to homeowners, and so on, none of whom may be 'needy' or 'disadvantaged'.

compelling case for public sector provision, because this serves to transfer 'income' to politically powerful groups in patterns different from those that would emerge from a combination of market forces and 'efficient' public sector intervention.<sup>4</sup> Importantly, on this view much public sector activity is thus likely to be focused on securing redistribution of income, not to the needy and disadvantaged but rather to whatever groups turn out to be politically decisive.

This is not to say that all activities will necessarily be overexpanded: the whole pattern of activity will tend to be distorted and conceivably some activities will be operated at inefficiently low levels if they predominantly serve the interests of less powerful groups. Nor is it to say that principles of equity and justice will be entirely ignored in determining public sector policy: majoritarian principles within constitutional constraints will ensure some redistribution from rich to poor in a generalised way. But within the general constraints either formally imposed by the constitution or less formally imposed by the need to sustain support for the institutional structures, there is a reasonable a priori presumption that we can expect to find considerable overexpansion and misdirection of public sector activity judged by conventional economic and social criteria.

### III. THE NATURE AND CONSEQUENCES OF PUBLIC SPENDING

Total public sector outlays in Australia (by Commonwealth, State and Local Authority Sectors combined) as a proportion of GDP was 43.4 per cent in 1985-86, or almost \$99 billion, as measured. Although not central to my themes, it is interesting to note that public sector outlays were apparently already a relatively high proportion of GDP around the time of federation, probably at least 15 per cent of GDP. Equally interestingly, of the 28 percentage point growth in the ratio since then, nearly half (12 percentage points) of the increase has occurred in the last 15 years, since 1970-71.

Rather more directly relevant to my theme, while Commonwealth Sector outlays alone amount to 31.7 per cent of GDP, once we net out the roughly 30 per cent of those outlays that are transfer payments to the

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<sup>4</sup> 'Efficient' public sector activity may be difficult to achieve even for an altruistic government, as Downs emphasises, because of the difficulty of obtaining appropriate information about preferences through political signalling devices. But the point here is much stronger: there are positive incentives to actually create inefficiencies, and voting and political signalling more generally are unable effectively to constrain these incentives.

States and local authorities, Commonwealth Sector and combined State and Local Sector outlays for their own purposes each represent about half of the total (21.3 per cent of GDP for the Commonwealth Sector, and 22.1 per cent for the State/Local Sector in 1985-86) — a situation that has apparently prevailed, roughly, since World War II.

Equally importantly, as I mentioned earlier, of total public sector outlays only a little over half (56 per cent of the total, or 24.5 per cent of GDP) represents net expenditure on goods and services (real resource use). The remainder involves transfer payments (personal benefit payments comprising 23 per cent of the total, interest payments 12.4 per cent, and subsidies to enterprises, grants, etc. 7.6 per cent) and (very small) net advances to the private sector. Between the Commonwealth and State/Local Sectors, however, the divisions between net real resource use and transfer payments differ substantially.

Over 75 per cent of the State/Local outlays are net expenditure on goods and services, involving provision of education services; hospital services; law, order and public safety; roads; public housing; community services; and local or regional public utilities (electricity, gas, water, sewerage, etc.). And of the balance, over half goes to interest payments on outstanding debt to the non-public sector.

For the Commonwealth Sector, by contrast, 64 per cent of its outlays on its own account are transfer payments, mainly personal benefit payments (46 per cent of Commonwealth outlays) and interest payments (14 per cent) with a small amount accounted for by subsidies, grants and advances to the private sector. Thus, net expenditure on goods and services accounts for only 36 per cent of Commonwealth outlays, defence accounting for over half of this and Commonwealth non-budget authorities (mainly national public utilities such as Telecom and Australia Post) the bulk of the rest.

Thus we have a picture of a public sector overall that is fairly big, in which outlays are split roughly equally between the Commonwealth and State/Local Sectors and (a little more roughly) between real resource-using activities and transfer payments. The State/Local Sector 'specialises' in the delivery of goods and services in education, hospitals, police, roads, housing and local public utilities. The Commonwealth Sector on its own account specialises in transfer payments (especially to persons, including Medicare) plus defence and national public utilities; but a large part of its total budget (about 30 per cent) represents revenue raised for transferring to the State/Local Sector — providing something like half the aggregate revenue of the State/Local Sector, nearly one-half of which is in the form of specific purpose payments.

All of these facts, and especially the fact that the States are major spenders in their own right but with substantial reliance on

Commonwealth revenue resources to fund them, must be taken into account in any attempt to analyse ways and means of reducing public sector outlays. At various points, the Commonwealth-State split will emerge as important to discussion of particular areas of spending, and I will briefly allude to Commonwealth-State financial relationships in the context of approaches to achieving continuing restraint. But for the moment I wish to focus more generally on economic aspects of various types of public spending.

### Exhaustive vs. Non-Exhaustive Spending

It is fairly conventional, but nonetheless important, to make a distinction between what are sometimes referred to as exhaustive and non-exhaustive expenditures.

As the term implies, exhaustive expenditures are those that directly 'use up' resources: they involve purchases by governments either of commodities (goods and services) produced by the private sector or of factor services (capital, land, labour) to enable the public sector to provide services (defence, education, health, communications, etc.) directly to citizen/voters. Although governments have the power (with some constitutional limitations) to compel individuals or businesses to supply their needs,<sup>5</sup> the acquisition of such goods and services is usually achieved through commercial transactions in commodity and factor markets. The provision of final services to citizen/voters, on the other hand, may be undertaken in a variety of ways, many of which do not correspond to commercial transactions of a market kind. The bulk of final public sector services (defence, education, law and order, roads, etc.) are provided out of general (taxation) revenue, more or less free of direct charge; many others are provided at less than market price, or even less than cost, either to all or to some users (transport facilities, public housing, medical and hospital services, etc.); and even the outputs of public utilities that are directly marketed may involve substantial subsidies from general revenue (e.g. railways) or cross-subsidies between consumer groups (e.g. telephone services).

This category of exhaustive expenditures roughly corresponds to the 56 per cent of total public sector outlays (24 per cent of GDP) that goes on net expenditure on goods and services — though, as previously observed, the fact that it is reported net of recoveries, charges, etc. understates the true extent of the public sector's using-up of real

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<sup>5</sup>Conscription being the most common example, perhaps, of effective compulsion, though on 'fair and reasonable' terms and conditions governments may also engage in compulsory purchase of land, etc. Purchasing policies (e.g. Australian preference and/or offsets) are worthy of investigation, though I do not attempt that here.

resources, which are thereby denied to private sector use.

Two further words of caution are also necessary. First, exhaustive expenditures (even measured gross) do not represent the full extent of the allocative impact of government. Quite apart from the impact of revenue-raising measures on resource allocation, the yet-to-be-discussed non-exhaustive expenditures (transfer payments) will also in general affect the allocation of resources, sometimes (e.g. through subsidies to enterprises) explicitly so; and some of the exhaustive expenditures (e.g. on legislative services) represent only the tip of a regulatory iceberg explicitly intended to affect allocative decisions. Second, exhaustive expenditures cannot be regarded as purely allocative: the way they are funded and supplied may have substantial impact on the distribution of well-being in society and in some cases (especially health, housing and education) there appears to be an explicit intention to engage in redistribution-in-kind.

Turning now to **non-exhaustive** expenditures, we are here referring to expenditures that do not in themselves involve governments using up resources. Rather, they involve transfers of purchasing power from taxpayers in general to particular nominated groups. While it is true that the largest part of this category of spending involves personal benefit payments (pensions, unemployment and sickness benefits, medicare benefits, family allowances), a significant portion does not. Thus, increasingly in recent times, a large element of the transfers involved in public sector outlays are interest payments to those who have been willing to lend to the public sector — a transfer from present period taxpayers to lenders to pay for the cost of earlier 'unfunded' spending. There is also a significant element of subsidies, grants, etc. to enterprises — transfers from taxpayers in general to encourage or underwrite particular private sector activities.

Clearly then, non-exhaustive expenditure (transfers) should not be confused with 'income transfers to the needy and disadvantaged' for a number of reasons. Even setting aside the 30 per cent or so of Commonwealth Sector outlays that are (net) transfers to the States and local authorities and the large reverse transfers in the form of interest payments by the States to the Commonwealth (which are netted out as transfers within the public sector), not much less than half of public sector 'transfer payments' are interest payments, subsidies, etc. Moreover, as noted above, the funding and supply of some public sector services have more or less explicit redistributive objectives. And even within the personal benefit payments sub-category of transfers, some (especially family allowances and medical benefits) are more akin to universal 'demogrants' than targeted transfers to the needy.

Equally importantly, transfer payments (non-exhaustive expenditures) are clearly not only 'redistributional' in their effects. We have already noted the (intended) allocative effects of subsidies and the

(incidental) allocative effects of benefit payments because of the different spending patterns of recipients and donors. But there is a broader point, too. As Browning and Johnson (1984) have particularly emphasised, tax/transfer arrangements can result in substantial losses of aggregate income through labour supply effects on both 'donors' and 'recipients' — a point to which I return later (see also Bascand and Porter, 1986, for some Australian estimates of these effects).

Finally, though implicit in all that I have said, in distinguishing between redistributive and allocative activities of the public sector, it is clearly not appropriate to focus on either 'Social Security and Welfare' outlays as a functional category, or 'Personal Benefit Payments' as an economic category, versus the rest. Something akin to a Social Expenditures Budget (incorporating much of education, health, housing and possibly other outlays) would be needed to secure a more accurate picture, though this too would be fraught with difficulties.

### **Evaluating Public Spending: General Principles, Strategies and Options**

With all this as background, I now turn to consider a set of general principles that might appropriately be applied in evaluating whether and where reductions in public sector spending might be achieved. Although application of these principles may be contentious in some respects, it seems to me that we might at least start from one general presumption that, as I see it, underlies Western liberal-democratic views about government intervention — namely that such intervention should occur only where a positive case can be made in its favour.

Appropriately conceived, this presumption requires that we start from first principles, and question the objectives of public sector intervention as well as the effectiveness of the implementation of programs and strategies to achieve those objectives. To suggest that something akin to 'zero base budgeting' is required is not to suggest that government might be reduced to virtually nothing. We can reasonably start with the presumption that people wish to provide assistance to the needy and disadvantaged — whether poor, disabled, sick, or whatever; that they wish to be provided with law and order, adequate defence, education, health services, housing standards and economic and social infrastructure; and that it is likely that some, and possibly all, of these objectives may need public sector assistance to secure their attainment at efficient or adequate levels. There is, nonetheless, a question of whether the forms, and the extent, of public sector assistance currently applied secure those objectives as effectively as possible.

It needs to be emphasised that the question posed here goes beyond examining the efficiency and effectiveness of programs as this is often (narrowly) conceived. As important as it is that public sector programs

be run with the minimum of resources consistent with attainment of their given objectives, this form of evaluation often presupposes not only that the pre-existing public sector involvement is unquestionably desirable but also that the existing public sector provision of services is beyond question as well.

As a form of evaluation, then, reviews of efficiency and effectiveness should be seen to logically succeed appropriate answers to a series of questions, the first and most important of which is: does the public sector need to be involved at all, or as much as it is?

Economists have devoted considerable effort to elucidating contexts in which market failure can be expected to occur, and increasingly to examining where, despite market failure, political failure may be even worse. Beyond the purest cases of pure public goods (goods for which simultaneous consumption by all is possible and for which rationing of access by price is impossible) — such as defence, basic legal structures and enforcement mechanisms, and possibly income redistribution — it appears an open question how good the relative performance of markets and political decision making is likely to be. Nonetheless, the concepts of public goods, externalities (incidental spillover effects), incomplete insurance markets (where moral hazard and adverse selection problems exist), non-competitive markets (especially where natural monopolies exist), and more contentiously, merit goods (where 'benefit evaluation' problems exist), as well as the need to care for the interests of the needy and disadvantaged, have been taken to justify wide-scale government intervention.

Unfortunately, the application of such concepts has given rise to at least three problems. First, creative minds have been encouraged to 'discover' examples of some form of market failure virtually everywhere, even where it seems clear that private rather than public interests predominate; second, little attention has been paid in any event to whether the market is likely to fail badly enough to warrant the presumption that public sector involvement will unquestionably improve matters; and third, there appears to have been a general, but totally unwarranted, presumption that where public sector involvement is considered necessary, public sector supply is generally required.

Each of these warrants more attention than I can give it, but the third raises particularly important matters that lead to the second important question to be posed in evaluating public sector activities: where public sector involvement is considered desirable, is public sector supply necessary and efficient or would subsidised private sector supply be more appropriate?

A number of issues raised in this context are fundamental to strategies and options for reducing public sector spending. As Minford (1984) points out, governments may supply goods and services in two alternative ways that — while interrelated — have essentially different

implications. It may, on the one hand, act as the producer, hiring capital, management and labour services together with intermediate goods from other producers, to produce final services for end-users (citizens and/or businesses). This it does not only in the case of public utilities — about which I shall say little because they are the subject of other papers — but also in the case of defence, education at all levels, some health services (principally hospitals), much public housing, law and order services (police, courts, etc.) and often in the case of roads and other construction activity, street cleaning and garbage collection, for example. And it does so a fortiori in the provision of administrative services in relation to the delivery of programs of personal benefits.

On the other hand, it may purchase more or less final goods and services from private sector firms to supply directly to individuals, often free or subsidised. This occurs, for example, with some public housing, some road and other construction activities, some medical services in public hospitals and (where bulk-billing is practiced) in doctors' surgeries, and so on. This case, of course, blends somewhat into the first, in the sense that governments choose the extent to which in producing final services they purchase or produce intermediate goods (e.g. armaments and uniforms for the defence services).

It is important to observe that in many cases where the government acts as supplier (whether producer or purchaser) it is not strictly necessary for it to do so: it does so as a matter of deliberate choice, in preference to allowing private sector production and provision with (where desirable) public subsidies to encourage the desired levels or standards of service. In many such cases, there appears to be substantial scope for reducing not merely public sector resource use but also total social resource costs by reversing this preference and/or substituting contracted private suppliers for public supply of services.

Aside from defence, the court system and some police services, for example — where issues of security, integrity, independence and confidentiality could reasonably be argued to imply public sector production as well as provision — at least contracting out of supply and often complete devolution of supply and sale (with subsidies where appropriate) seems possible throughout the public sector where production now occurs.

As Minford convincingly argues, where there is public production, there is a tendency for the public sector producer to be protected from competition, by being given either effective monopoly rights or privileged conditions; and this applies far beyond those providing marketed services. In the case of utilities, for example, even where private supplementation or competition is allowed it is often limited (e.g. by common carrier provisions) or disadvantaged (by loan guarantees, tax treatment, dividend policies, and outright public subsidies to the public supplier). In the case of education and hospitals,

state institutions are protected in various ways, including especially through differentially large contributions from general revenue to enable free or virtually free services on a universal basis (i.e. not just to the needy and disadvantaged). And in the case of health insurance, private competition is prevented in the compulsory core of the state scheme, and private supplementation is limited as well (e.g. in relation to gap insurance and so on).

The social costs of this protection of public sector production are, however, substantially larger even than Minford suggests. In the case of marketed services, the protection offered allows prices to be pushed above costs of production with a consequent so-called deadweight loss to society arising from the fact that output tends to be lower than with competitive private production. These losses alone, he suggests, might be valued at as much as 10 to 30 per cent of turnover in relevant cases (one might add, of course, that other costs may occur, such as a slower rate of adoption or search for improved technology). However, even in the case of marketed services the social cost is likely to be much higher than this, because the protected public sector suppliers are likely to seek to — and, to a greater extent even than monopoly private sector suppliers, be able to — convert what otherwise would be profit (payable into general revenue, or to finance capital expansion) into 'rents' to the workforce and management, in various ways pushing up the costs of production relative to those that would apply with private production.

Of course, monitoring devices will be applied to attempt to limit these consequences, and public sector organisations are likely to be forced into undertaking activities that private sector counterparts would not, using cross-subsidies and so on (see Hartley and Trengove, 1986, for a recent fascinating analysis of such issues). But in a sense this merely limits and changes the form of the extra costs rather than eliminating them.

For the non-market services that are of more direct concern to us, related implications apply. As I noted earlier, Niskanen (1971) has argued that, in extreme cases where 'bureaucratic' control is complete, the costs of public supply would be virtually as large as the entire benefit that would accrue from market provision. In most cases, it seems more likely that public supply of non-market services will involve overexpansion of output rather than underexpansion, and/or that costs will be higher than for market counterparts,<sup>6</sup> as public sector suppliers attempt to capture the benefits of their privileged positions.

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<sup>6</sup>American commentators (e.g. Tullock, 1983) often claim that public sector costs emerge to be twice those of private sector suppliers in similar circumstances. Davies (1971, 1977) among others has reached similar conclusions about Australian airlines. See Domberger and Piggott (1986) for a survey, though it relates more directly to public enterprises.

And there are, in fact, other sets of likely costs that these arguments have not taken into account, such as those that arise from the tendency towards uniformity in public sector provisions (e.g. in education) irrespective of preferences among citizen/voters, and the use of non-price rationing devices (e.g. queues and delays in public hospitals) where services are free or significantly subsidised but the public sector is not prepared to meet the full demand at the prices set.

The full extent of the 'excess social costs' of public supply is difficult to estimate, being likely to vary from case to case and depending to a significant extent on the degree and forms of private sector competition or supplementation allowed. Nonetheless, it seems unquestionable that there are strong a priori grounds for believing that public sector supply is a very expensive alternative to competitive private sector provision, even allowing for the possibility that subsidisation of private provision may be desirable to secure appropriate levels or distribution of services. Minford's estimates of social costs of 10 to 30 per cent of relevant budgets may indicate only the minimum cost range in many cases.

Accordingly, devolution of supply of services to the private sector should be a high priority target for reducing public sector spending and taxes: the aggregate costs, public plus private, could be considerably reduced. Major potential areas for such devolution would appear to be education at all levels, hospital services, health insurance and public housing. In some of these cases, some setting of standards and other public interest regulation may be desirable, as might subsidisation of consumption for some or all users. But in themselves such arguments do not detract from the general case for moves towards devolution.

Other cases where similar principles might apply (other than public utilities where they apply a fortiori) would include local garbage collection, possibly the provision of toll roads and bridges, conceivably even some dimensions of police services. Some of the complexities in these cases might, however, imply that franchising or contracting out would be more likely approaches. Here, however, it may be possible to consider changes to financing arrangements that would also serve to better economise on public resources.

This leads me to a third question relevant to evaluation of public spending: where public supply remains, to what extent might user charges (fees, recoveries, etc.) or user taxes (special tax levies) be preferable to general revenue funding?

At one level, charging policies and/or earmarked taxes might simply be seen as different ways of funding services, rather than fundamental means of reducing outlays. To some extent this is true (though charges, fees, etc. under current public sector accounting conventions would have the cosmetic advantage of reducing outlays as recorded, since they are netted out) — especially in the case of earmarked taxes or user levies.

However, even these may serve the useful purpose of better highlighting the cost of supplying particular services if they are required to be set to cover full costs (unlike the current Medicare levy) and explicitly adjusted annually if costs are anticipated to increase. Special levies to fund the Australian Broadcasting Corporation (ABC), grants to cultural activities, support of sport, all road construction and maintenance, and possibly many social insurance outlays, for example, could be argued to be justifiable in these terms, and the more so if a base for the levy can be related indirectly to use.

Fees and charges, on the other hand, may serve more directly the interests of restraining or rationalising spending, since they may better ration use of services in some cases. Though possibly distinctly second-best to other approaches noted above, this may be the case for publicly-supplied education and for health and hospital services, and may indeed in some cases form the basis of an alternative approach to devolution to private supply, where public institutions are allowed (required) to fund a more substantial part of their activities directly from fee income, with public sector subventions correspondingly reduced.

In relation to this argument — and perhaps more so to the earlier suggestions about private provision of currently (largely) publicly supplied services — there may well be those who would argue that moving to more market-like prices would harm many of the needy and disadvantaged. To address this, I turn to a final series of questions relevant to such issues: are all income transfers, implicit and explicit in current spending, policies required for reasons of social equity or justice? Who should get such transfers and what form should they take?

As I indicated earlier, not all transfer payments as recorded in budgets are strictly for interpersonal redistribution purposes; neither do personal benefit payment figures reflect fully the extent of policies apparently designed to serve redistributive objectives. Part of the transfer payments reflect subsidies, grants, etc. to enterprises, which in principle should reflect market failure arguments for expanding private sector output of particular goods and services. As with other areas of the budget, the case for such subsidies needs to be carefully scrutinised, not merely in terms of effectiveness but also in terms of the objectives. Many such subsidies may simply reflect, albeit in a minor way relative to other mechanisms used for this purpose (especially regulation and protection), income transfers sought and obtained through the use of privately interested political power rather than for truly public interest purposes. Where such subsidies are explicit, they are at least visible to scrutiny and, despite its apparently adverse effect on budget aggregates, the strategy of converting implicit subsidies (tax expenditures) into explicit subsidies would at least be a start along the path towards eliminating those that reflect political exploitation, and that involve

substantial income transfers to groups nowhere near being needy and disadvantaged.

Even among programs with more explicit redistributive intent, it would have to be conceded that much current activity has little to do with redistribution to the genuinely needy and disadvantaged — especially, though not exclusively, where redistribution-in-kind is argued to be the essential objective. In the case of education, health, and even public housing, pricing policies are pursued that, it is argued, ensure equality of opportunity or access to low income or otherwise disadvantaged individuals. As a matter of principle, there are substantial objections to using programs of redistribution-in-kind rather than cash transfer programs, in the sense that the former involve the possibility of paternalistic imposition of the preferences of the non-poor on the poor.

It may be argued, of course, that the sustainable size of transfer programs to the needy is enlarged by giving in-kind transfers, in the sense that donors are willing to give more when much of the assistance is 'tied' than when it is 'untied'. To the extent that this is so, it may constitute a case for means-tested (or circumstance-tested) benefits in the form of housing, health and education subsidies. But much current 'in-kind redistribution' is not targeted in this way. Public provision of education at all levels virtually free of charge to all who want to gain access to it, and access free of charge or at highly subsidised rates to public hospital services, and in effect to many medical services too, are poorly targeted substitutes. And in relation to public housing (let alone housing in general, despite means-testing of first home-owner scheme funds), below-market rentals encourage continued residence by non-needy tenants while many of the 'after-housing costs' working poor (who do not get 'supplementary assistance') face unsubsidised market rentals in the private rental market.

To the extent that the tax system ensures funding is income-related, there is, of course, some redistribution occurring in most of these cases, except with higher education where access is rationed and current policies involve substantial redistribution in favour of the already well off or soon to be well off. But even more generally, the effective provision of demogrants reduces substantially the extent of real (and desirable) redistribution that occurs for a given public sector outlay. There is here (as in other areas of explicit welfare spending) much 'churning' — raising of revenue from and provision of benefits to essentially the same group of people. And as I indicated earlier, it is not just that the exercise seems pointless, nor, more to the point, that it involves unnecessary administrative costs on both sides of the transactions; more importantly still, given labour supply effects and other sources of excess burden, the cost of a dollar transferred to the genuinely needy is likely to be very high (see Browning and Johnson, 1984, and Bascand and Porter, 1986).

Even those averse to private supply of education and all health and hospital services and insurance, and in favour of substantial welfare benefits including some in-kind, should favour elimination of 'free-access' to many public services and the introduction of market-like fees and charges, with means-tested subsidies to particular categories of individuals — whether low-income or chronically ill or whatever. Private competitive supply, rather than public supply, as I argued earlier, would free yet more resources and lower overall social costs — a presumption that applies to public housing too, where around \$1 billion (net) of Commonwealth and State funds are devoted to public housing construction and as much again to housing assistance. Over time, allowing the private rental market to supply all but emergency accommodation and providing strictly means-tested rental assistance to needy renters would be a much more cost-effective and better targeted way of using public funds.

Turning now to the personal benefit payments, there are more diverse programs here than I can hope to deal with, other than at the level of general principle. In this regard, one point I would make strongly is that, contrary to Minford (1984), it is not clear to me that income maintenance or negative income tax programs for the support of low-income families are desirable. As Bascand and Porter (1986) suggest, given the costs of equity/efficiency trade-offs, broad-based programs and demogrant-type schemes (such as family allowances) may be very costly compared to more narrowly targeted programs, despite problems over some ranges with effective marginal tax rates. Particularly given the often temporary and/or life cycle nature of 'need', programs with easy (but monitored) access and rapid exit (albeit across high effective marginal tax rates over short ranges) may be much preferred.

Second, and relatedly, some of the problems in the welfare budget (e.g. with sole parent benefits) arise from poorly designed schemes and/or a failure to fully administer the programs as originally intended. The social security and welfare area apparently takes pride in having very low administrative costs, but it might be argued that higher administrative costs would be desirable if they resulted in better targeting of the intended beneficiaries.<sup>7</sup>

The whole issue of the interaction between the welfare system and the tax system is in need of further review despite some recent work on

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<sup>7</sup>Cases-in-point cited to me include 'non-eligible' non-residents gaining access to benefits, failure to apply work tests, and the actual encouragement of people to gain access to benefits by arrangement of their affairs. On the other side, many genuinely needy, diffident about dealing with welfare people, probably do not gain access to full entitlement.

it. Apart from the still somewhat vexed question of pension means-testing and the issue now being tackled of sole parent benefits, the outstanding (though somewhat contentious) case in the income transfer area is that of family allowances. Now that family income-testing applies to the family income supplement for the working poor and to family allowances for 16- and 17-year-olds, its extension across the board would seem both desirable and more politically feasible than it has previously seemed. The extent of transfers to high income families and more generally of much 'churning' across the board must make it a prime target, with both tax cuts and increased benefits for genuinely low-income families made possible as offsets.

Finally, in relation to cash benefits, the issue of unemployment benefits has been revived in recent times with discussion across the political spectrum of work-for-the-dole schemes, especially for young people. At the most general level, it might be observed that much of this (and other welfare) expenditure may be attributable to compensation for other policy failures in relation to education, wages and training in particular, and the most effective expenditure cutting strategy may be to tackle those other problems. More specifically, however, a move towards a national employment insurance arrangement and/or the restriction of benefits to some proportion of previous earnings for durations related to work experience would seem worth particular consideration as a means of helping to create greater incentives to escape from beneficiary status. This is not to deny the case for a safety net of some sort, of course, but simply to recognise that incentive and disincentive issues are fundamental, even in a caring society.

#### **IV. FROM INITIAL REDUCTIONS TO SUSTAINED RESTRAINT**

This rather lengthy discussion of general principles has, inevitably, been illustrated with a relatively limited range of examples drawn predominantly from education, health and public housing, and (though less specifically) social security and welfare spending. That these should turn out to be the major illustrative examples (given that I have explicitly excluded public utility 'privatisation' from my considerations) is not surprising.

Although more detailed scrutiny of other areas of the budget in terms of the principles outlined here, and reviews of efficiency and effectiveness more narrowly conceived, might yield in aggregate large potential spending reductions (and/or offsets to outlays through more effective application of fees and charges for services), substantial targets for significant and sustainable cuts in real terms in outlays are likely to come from areas of activity that can be in large measure 'handed back' to

the private sector — albeit with subsidies particularly to needy users and/or to private producers to ensure adequate overall levels of provision and consumption. While there may be more egregious cases of public sector intervention that serve only private interests or otherwise have little social value and could be cut with relative impunity, education, health and public housing construction represent major cases where partial market failure and redistribution-in-kind arguments for public support have been overextended into strongly questionable cases for public supply of schools, hospitals, houses, insurance, and so on, usually at highly subsidised direct charges and often universally available at those charges.

On currently available figures, these three areas account for approaching \$30 billion (or nearly 30 per cent) of total public sector outlays. If only as much as one-third of these outlays could be cut (net of subsidies required) by progressively devolving supply to the private sector (or, less satisfactorily but perhaps more immediately attainable, by increasing direct charges and requiring the institutions to fund spending from this revenue), substantial progress would have been made towards reducing public spending without sacrificing publicly-shared objectives. Indeed, both from improved efficiency in supply and from reduced tax-induced distortions, these strategies could yield substantial net social benefits, which, after all, is the central justification for reducing public sector activity by returning functions to the private sector.

Application of similar principles to other non-market public sector services, franchising or sale of commercial public utilities (even with residual regulations in some cases), more vigorous means-testing of all forms of welfare benefits, and continuing reviews of efficiency and effectiveness across all public sector activities, including in the problematic area of defence, could conceivably see public sector spending reduced to shares of GDP more like those that prevailed before the 1970s — and again, I emphasise, without society giving up any of its major objectives.

It is interesting to note two things about these strategies. First, a substantial part of the reductions would occur at State level — not surprisingly, since the States are the predominant users of real resources. Second, notwithstanding this, and in any event noting that via grants many of the relevant State activities are effectively substantially Commonwealth funded, the strategies discussed here contrast rather starkly with the supposedly major cost-cutting exercises of recent memory — from Bland, through Lynch, to the 1986 Budget.

This is not to reject as totally insignificant the latest Commonwealth round of expenditure cuts. Even though in aggregate they left spending unchanged in real terms — and indeed allowed the Commonwealth's own outlays (especially in goods and services) to

expand in real terms by imposing severe cuts in capital transfers and advances, especially to the States — amid the much derided deferrals, minor increases in charges and recoveries, and minor program cuts and administrative improvements, two or three potentially significant changes were made. For example, a complete program of bed-day subsidies to private hospitals was eliminated. (Though this could be argued to be inappropriate in reducing effective private competition with publicly funded and protected public hospitals, the principle of eliminating programs is nonetheless important.) Apparently minor administrative charges for tertiary students were introduced, opening up the possibility of genuine tuition fees. An initial attack has begun on the much-abused sole parent benefit scheme, and the introduction of means-testing of family allowances for 16- and 17-year-olds offers a potential wedge towards application of this principle across the board for family allowances. Whether these hopeful signs turn out to be harbingers of more significant things to come remains to be seen, but their potential significance cannot yet be ignored.

What can, unfortunately, be said of the 1986 Commonwealth Budget exercise, like most exercises before it, is that these few signs apart, it is difficult to see that the measures adopted provide any major protection against the apparently inexorable rise in the cost of public sector services. This leads me to a final general (and I think vital) point about strategies for reducing public sector spending — namely, that the benefits may be rapidly dissipated unless equally substantial attention is given to 'control mechanisms' designed to resist renewed growth of spending. Since others are to discuss these issues in detail, I shall merely identify some of what might be seen as essential elements of securing control of spending growth, especially at the Commonwealth level.

At the micro level, there is the need on a continuing basis for rolling programs of policy and program reviews, evaluating efficiency, effectiveness and strategic policy issues: the only alternative would be the crude instruments of cash and/or staffing limits.<sup>8</sup> Clearly, such reviews would need to be considered an integral part of the budget process, which itself might benefit from further review — especially with respect to the role of the Forward Estimates of Expenditure, which, despite better integration in recent years into the budget process, remain essentially an instrument of the annual budget cycle rather than an instrument of longer-term planning for flexibility (see the CEDA, 1986,

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<sup>8</sup>The proposed introduction of program budgeting as well as the reviews to be undertaken as part of the Prime Minister's package of measures to improve public sector management and administration may play part of this role. But there is a risk of them being little more than window-dressing unless they are part of an integrated attack on spending growth.

report on strategic planning issues, and the House of Representatives Expenditure Committee's 1979 report on Parliament and Public Expenditure, which also had much to say about these and related issues that remain relevant today).

Over and above this, and indeed perhaps because of it, is the need for more macro level controls. Trilogy-type commitments — or the Opposition's more austere version — may serve as suggestive models once base level spending has been appropriately reduced. Of more automatic effect, and to that extent at least equally important, is the possibility of trying again to establish thorough-going indexation of the tax system. At a yet higher level still, and correspondingly less secure of achievement, would be some form of constitutional limitation on spending. This raises particularly complex issues, but it is worth noting in passing that one existing form of what is arguably intended as a constitutional limitation has been substantially perverted, especially since World War II — namely, the constitutional division of spending and especially taxing powers. While the conventional wisdom in Australia has it that Commonwealth dominance is necessary to secure any reasonable restraint by the States, this dominance is secured at the cost of relieving States from unambiguous responsibility for their decisions and partially shielding them from bearing the full political cost of irrational decision making. It seems to me at least that the issues involved are less clear-cut than is currently admitted.

## V. CONCLUDING REMARKS

Governments have proved themselves to be pretty adept at increasing spending: one might almost say they are naturals at it. They have yet to prove themselves anywhere near as adept at controlling and reducing spending. Despite some changes in perspectives on government and its performance as a supplier of services, which have given rise to a generalised 'public will' to reduce spending, the requisite 'public way' has not yet been found.

What I have suggested is that the 'public way' probably has at least three important elements. First, it requires that public services be scrutinised not just in terms of their efficiency and effectiveness, but in terms of more fundamental questions about whether public provision is really necessary and desirable. Second, it also requires 'packaging' of proposals in ways that emphasise, for some, trade-offs in terms of reduced tax burdens, and for others, more generous and better targeted benefits. Third, but equally fundamentally, it requires identification of procedures and/or processes that both help to sustain cuts once made and, indeed, give those with responsibility for determining spending levels and patterns a continuing interest in making savings.

*Restraining Leviathan*

I have attempted to identify some of the relevant elements but, at this stage, have gone little further than stating principles and suggesting illustrative examples. The real work starts from here.

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*Restraining Leviathan*

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# COMMENTS

*Peter Swan*

Rather than commenting in detail on the themes raised by these two excellent papers (with which I find myself in substantial agreement), I would like to add to their impact by discussing some of the causes and effects of the growth of government in Australia.

A recent study by Michael Marlow (1986) of the effects of government growth in a number of OECD countries (including Australia) between 1960 and 1980 finds that the contemporaneous increase in public expenditure by itself has had no effect in reducing the rate of economic growth, but that the level of government expenditure as a share of GDP has quite a large negative impact in reducing the subsequent rate of economic growth. Given the very high current level of government spending in Australia, then, if Marlow's hypothesis is correct, we can look forward to even lower economic growth rates in future than we've experienced in the past. That would be a hard target to achieve, given our miserable performance to date.

Professors Minford and Walsh have mentioned some of the factors that have been put forward to explain the rising share of GDP taken by public expenditure, factors such as budget-maximising bureaus, majority voting rules, and the growth of special interests. Mueller and Murrell (1985) find that the size of government in the OECD countries is positively related to even a very crude measure of the number of special interest groups. Among the other factors that have been suggested, that of voter myopia is especially important.

For myself, I have approached the issue of the growing size of government in Australia by asking whether the voters have ever been asked whether they want a larger public sector. Over the period 1950-1984, for example, the revenue share of GDP for the Commonwealth and State governments combined rose from about 23 per cent to just over 30 per cent, and expenditure rose from about 28 per cent to over 42 per cent. The difference is largely due to government borrowing. Have voters ever been asked whether they wanted those rising shares of revenue and expenditure? I have tested this by a simple

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procedure. I asked what factors have entered into these rising shares, and tried a number of variables.

Recall that during the period 1972-74, the Whitlam Governments, despite their large expenditure programs, were embarrassed by the volume of revenue they were collecting as a result of the fiscal drag caused by high inflation rates. Admittedly expenditure rose by even more than the considerable rises in revenue over the Whitlam years, but there may well have been expectations that the deficit could be funded from future fiscal drag. I tested an explanation containing two variables: the price level (measured by the implicit price deflator for GNP), and the political colour of the government (which I lagged by two years to ensure that the expenditure programs in the second year of government would be impacted by this measure). I found that both revenue and expenditure shares of GDP could be explained by these two variables, most of the explanation being provided by the price level. The term reflecting the change of government came in positive, with the Labor government winning the honours. This indicates that these large increases have occurred without any explicit tax increases. Governments wanting to raise expenditure have only had to print a little money, generate some inflation, or fix the exchange rate so that inflation is generated. Because of the nature of our marginal tax brackets and the absence of any indexation for inflation in the tax system, fiscal drag has been sufficient to increase revenues substantially. Since governments have been unable to resist spending the additional revenue, inflation goes a long way towards explaining the increasing share of public spending in the GDP as well. Other factors have also been at work, but the price level variable by itself does go a long way towards explaining the growth of government. For every 10 per cent rise in prices (roughly our current inflation rate), revenue and expenditure rise by about 1.65 to 1.70 per cent of GDP. If, as seems likely, inflation continues at its current rate for many years, we can expect continuous increases in revenue and expenditure. Because of the progressive nature of the income tax system, this can remain true despite the tax 'cuts' that governments might introduce. (For a fuller treatment see Swan, 1987.)

One solution would be to reduce marginal tax rates so that they were roughly equal to average rates. This would kill two birds with one stone: First, it would improve the efficiency of the tax system by eliminating some of the distortions and disincentives that Professor Minford shows to result from high marginal tax rates. Second, by reducing automatic increases in tax revenues, it would force governments to be honest with the voters: if they want to raise the public spending share of GDP, they would have to ask the voters to agree to the tax increases needed to finance them.

Another variable that does as well as the price level as a predictor of the increasing share of government revenue and expenditure in GDP is

the number of times a taxpayer's income has to exceed the average weekly earnings before he is in the highest marginal tax bracket. In 1950, this was 20 times. In 1984, it was roughly two times. Today, it is probably about one and a half times. This means, in effect, that the government has ameliorated the problem of the difference between marginal and average tax rates by generating enough inflation to almost push everyone into the highest marginal bracket. Once the average tax rate for most taxpayers nears the top marginal rate, fiscal drag is no longer such a powerful force.

A reform of the tax system is, then, a first and an essential step in improving our expenditure system and forcing governments to be honest.

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## DISCUSSION

**Edwin Brooks (Riverina-Murray Institute of Higher Education):** Professor Minford seems to argue that privatisation is a necessary precondition for developing a genuinely free market. Yet he glosses over the failure of the Thatcher Government to combine privatisation with any sort of competitive thrust within the former state-run industries. If one simply hands over public enterprises to very large monopolies (possibly transnational) then one may be changing the permutations of power but not creating a genuinely competitive economy. I have two questions: Why did the Thatcher Government not combine privatisation with deregulation (as when it sold Telecom)? And how does one proceed thereafter without denying those who purchased Telecom the benefit of the structure which they thought they were purchasing?

**Patrick Minford:** Private monopolies are better than public ones, because contestability — the threat of entry into their markets by competitors — is at least a possibility in the private sector. With public monopolies there is no such prospect.

As for the shareholders of Telecom: they were sold a prospectus in which they were to have a regulated private monopoly, with one minor competitor, namely, Mercury. But the guarantee extends only five years from the date of privatisation. Anyone who bought Telecom shares must be aware of the possibility that Mercury could become more powerful, and that other competitors might be allowed into the market when those five years have expired. The big challenge for privatisation is turning regulated monopolies into contestable ones. It's very hard to privatise public sector monopolies where the managements are totally hostile, and the only way of persuading them not to sabotage the whole operation may well be to retain monopoly regulation. But once they are in the private sector, it should be easier to deal with them.

**Simon Oke (Liberal Party of Australia):** Professor Minford stated that an efficient tax system is one where marginal tax rates are similar for all individuals. I assume he is referring to effective rates, i.e. the nominal rates plus any means-testing effects. Professor Walsh, on the other hand, stated that there was a case for distributing some income transfers as rebates, and for means-testing some such rebates over a

narrow fence, certainly at a higher means-testing rate than over a longer fence. If we agree that the tax and benefit systems should be integrated, and if we also agree that a 'flatish' tax system minimises disincentive, then would not a system of means-testing rebates over narrow fences be at odds with those principles? And given that the tax system is at present highly progressive but family allowances are flat, would Professor Walsh's proposal for means-testing family allowances create an even more progressive tax-benefit system?

**Minford:** It's true that, under a negative income tax, there's a trade-off between the minimum income and the degree of progressivity. If there is a high level of support, and you want a low marginal tax rate or a low rate of withdrawal, you have to provide the support a long way up the income scale, which is expensive. I see merit in Professor Walsh's scheme in which benefits are narrowly concentrated, so that there are very high marginal tax rates just as you disqualify for the benefits, but at least the number of people affected is small. Over this part of the income scale you are forced into something unsatisfactory by the desire to provide a safety net. I think my own Negative Income Tax proposal is the least unsatisfactory, because it can be restricted fairly narrowly — you can come up with marginal tax rates of 60 per cent over a fairly moderate range.

**Cliff Walsh:** On family allowances: there is a substantial amount of evidence that taxing everyone in order to provide benefits for everyone makes no sense (and we should remember that the tax system is in fact roughly proportional, not really progressive), since the labour supply effects on both taxpayers and recipients impose costs in excess of the value of the transfers. As for the guaranteed minimum income, I'm not sure that it's the most desirable mechanism, since a lot of people (such as students and part-time workers) are on low incomes only very temporarily. I also fear that we would be under constant pressure to raise the minimum, which would impose serious costs in terms of labour supply effects.

**Peter Saunders (Social Welfare Research Centre):** Professor Minford referred to the poverty trap and the unemployment trap in the UK. As I understand it, the poverty trap arises because of the withdrawal rate of benefits, whereas the unemployment trap arises because of the level of benefits. Avoiding the poverty trap involves reducing the withdrawal rate, which increases public spending; whereas avoiding the unemployment trap involves lowering benefits, thus reducing public spending. Was Professor Minford proposing to lower the withdrawal rate or to cut benefits?

**Minford:** The major savings come from springing the unemployment trap. The savings there are very large. But it needn't involve cutting benefit rates. The British government has recently begun the 'restart' program, under which the long-term unemployed are interviewed by public servants and offered opportunities in training and jobs. Those who persist in declining job opportunities are liable to lose their benefits. Those who are genuinely unable to find work remain entitled to unemployment benefits. The system seems to be working well at the moment leading to substantial savings. This is all within the spirit of the Beveridge reforms.

**Saunders:** Professor Walsh may be right in arguing that there is a movement for lower taxes in Australia. But this seems to me to be a mainly middle-class movement. Does he believe the movement would persist if it were understood tax cuts would have to be financed by cuts in benefits for the middle class?

**Walsh:** I think so, because the only way to cut taxes is to cut spending. Peter Swan touched on this issue when he noted that the Australian people had never been asked whether they wanted public sector spending to rise by so much. If people were asked this question in a way that made sense, I think most of them would favour a smaller public sector. But it's hard for them to act on this preference, since in supporting the benefits that are important to them individually, they have to support similar benefits for everyone. There is a kind of schizophrenia here, which can be resolved only by the appropriate political processes.

As far as federal fiscal processes are concerned, I don't think it follows that support for smaller government requires us to call on the the Commonwealth government to wield the big stick at meetings of the state premiers and the Loans Council. It might be better to restore full taxing and borrowing powers to the states and require them to carry the entire cost of their own decisions.

# **Business Regulation — Its Scope, Costs and Benefits in Australia**

*A.J. Moran*

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Views expressed in this paper do not necessarily represent the views of the Commonwealth government.

# Business Regulation — Its Scope, Costs and Benefits in Australia

*A.J. Moran*

## I. THE SCOPE OF BUSINESS REGULATION

Regulation reaches into all activities. In many of its guises however it is little more than a codification and elaboration of common law. Common law or natural law is the basis on which property rights are defined, and it allows contractual arrangements to be made in an atmosphere of some certainty.

Where it is consistent with common law, regulation often performs an indispensable role, as in the case of much of company law or patent law. In such cases, the role of regulation is largely to codify common law and update it for changed commercial and technological circumstances.

Mitnick (1980) has offered a lengthy definition of regulation, which can be summarised as 'restriction through deliberate intent of a subject's choice of activity by a public administration entity not directly party to or involved in that activity; and policing of that restriction with respect to a goal and according to a rule prescribed in the public interest'. The difficulty of this definition is that it leaves vague the role of taxation and subsidies. The Business Regulation Review Unit (BRRU) adopted the following definition of regulation: 'actions of government, which whether by use of fiat or inducement persuade business entities to pursue their commercial interests in ways they might otherwise not have chosen'. This is also far from perfect. Whatever definition is applied has as its basis the power of the state, a power that Stigler (1971:4), with commanding rhetoric, described in the following terms: 'the State has one basic resource which in pure principle is not shared by the mightiest of its citizens: the power to coerce. The State can seize money by the only method which is permitted by the laws of a civilised society, by taxation. The State can ordain the physical movements of

resources and the economic decisions of households and firms without their consent'.

Like a great many Western economies, Australia has a vast apparatus to regulate business. It is often said, and it is certainly no exaggeration, that the average milkbar needs as many as 16 or 20 separate regulatory approvals to open its doors. While many of these do not impose particularly onerous conditions or seriously inhibit entry into the service, they must add appreciably to costs. Other activities are subject to similar levels of regulation, much of which significantly affects the way firms do business. And the intrusion of regulation has clearly gathered momentum over the past 20 years. Although nobody has made a recent accurate count, there are of the order of 55 000 laws regulating the pursuit of business in Australia. Numerically, regulation in Australia is therefore vast.

In scope Australian regulations include: embargoes on certain activities; the requirement to obtain prior permission from the authorities — permission often associated with activity-specific taxation; and particular requirements specified as conditions of being allowed to engage in certain activities. It may also include subsidies, which though not coercive have regulatory intents and effects similar to penalties.

To give an example of the scope of regulation let's assume we were to go and buy an egg and mayonnaise sandwich. The sandwich shop would be subject to many of the 16-20 regulations to which such shops are subject, including hygiene, zoning laws, possibly trading hours restrictions, regulations covering wages, permits to sell tobacco, possibly alcohol, milk, and so on. The eggs would be produced under a quota system. The bread would be produced under definitional laws, be subject to packaging, labelling, and 'use-by' laws, baked within severely restrictive hours, in factories subject to hygiene and occupational health and safety regulations. The mayonnaise would be produced subject to its own packaging, labelling and content laws; one of its key ingredients, sugar, would have been produced under a highly regulated quota system. The butter would be produced under dairy industry regulatory arrangements and manufactured subject to health, occupational safety and wage determinations. The total number of regulations governing purchase of the sandwich would amount to several dozen.

The problem with using examples such as this — and indeed in counting the numbers of regulations — is that the economic distortions are not really illuminated. At least the shopkeeper can sell you an egg sandwich and plenty of them are able to do so. For other goods, like air transport or radio transmission, rather fewer laws prevent the service being tendered at all except by those privileged to be already offering it.

### **The Government's Approach**

The tone of the federal government's approach to deregulation was set by the Prime Minister when he addressed the Business Council of Australia in September 1984. On that occasion the Prime Minister said, 'I am convinced that after 84 years of federation, we have accumulated an excessive and often irrelevant and obstructive body of laws and regulations. We will examine critically the whole range of business regulation, most importantly with a view to assessing its contribution to long-term growth performance. We will maintain regulation which upon careful analysis clearly promotes economic efficiency, or which is clearly an effective means of achieving more equitable income distribution. And we will abandon regulation which fails these tests'.

The dominant theme running through this quotation refers to 'excessive and irrelevant regulation'. This offers a clear signal favouring deregulation — perhaps the clearest such signal ever given by an incumbent government in Australia. But it is tempered by the agnostic view that some regulation promotes economic efficiency and that some regulation may be a justifiable means of promoting equity in income distribution.

There are therefore three themes: first, the market is operating less efficiently as a result of being overridden by regulation; second, some regulation improves the efficiency with which markets operate; and third, some regulation, though detracting from efficiency, is nonetheless warranted on equity grounds.

### **Broad Types of Regulation**

Regulation is designed to overcome market failure. It is commonly categorised by its purpose into **social and economic regulation**, though many regulations straddle the two aspects.

Economic regulation may

- promote competition;
- prevent monopolistic exploitations;
- be a means of rationing certain scarce goods;
- seek to foster economies of scale; and
- compensate for certain community-wide gains that transactions fail to recognise.

Commonly it also has the effect of advantaging certain sections of the population by, for example, conferring tariff advantages or subsidies on domestic producers or protecting incumbent firms through a licensing system.

The state frequently seeks to prevent monopoly exploitation by itself undertaking the production or supply of the goods or service likely to be monopolised. Other forms of economic regulation operate by directly guiding the price at which goods or services might be sold, specifying who may or may not compete in certain markets, or requiring the use of particular distribution modes; often a combination of these means is employed.

Social regulation may

- set standards for safety;
- promote desirable environmental characteristics;
- foster greater equality for certain groups;
- mandate health protection measures; and
- specify remuneration practices, working hours, etc.

Social regulation therefore differs from most forms of economic regulation by requiring that certain costs must be internalised within a firm, leaving the market to make the appropriate price adjustments.

## **II. THE GROSS COSTS OF BUSINESS REGULATION**

### **Overview**

Recently we at the BRRU published information that sought to establish some overall costs of business regulation, following on the work of Weidenbaum (1978). Costs were disaggregated into three related components: public resources, paperburden and compliance costs.

Public resources as measured by the number of Commonwealth public servants were estimated at between 16 400 and 32 000. The latter figure includes estimates of numbers employed by the Australian Taxation Office, the Australian Bureau of Statistics, and some other policing and information-gathering agencies. Adding in the number of State and local authority officials, amounting to some 50 per cent more than those employed by the Commonwealth, the total number of government officials involved falls within the range 40 000 to 80 000. The annual costs of these officials to governments would amount to between \$1.8 billion and \$3.6 billion.

Paperburden costs to business of furnishing government officials with appropriate information to allow regulation is subject to a number of estimates. In the United States, the Federal Paperwork Commission has published estimates placing these costs at over five times those of the government. Based on a limited survey published by the Confederation of Australian Industry in 1980, we opted for a more

conservative figure of two times the costs incurred by government. This results in paperburden costs to industry in the range of \$3.6 billion to \$7.2 billion.

The more significant costs — and the area from which benefits are expected — are in the compliances required of business. Compliance costs include such matters as factory modifications, increased prices as a result of entry barriers, product modifications and so on. Weidenbaum drew upon dozens of separate studies to compile regulatory compliance costs, and related these back to the public resource costs incurred by the US federal government. He generally adopted the more conservative estimates where a range of studies was available. In aggregate these compliance costs came to a value equal to 20 times the expenditures directly incurred by the federal government.

The BRRU opted for a compliance cost figure of ten times public expenditures. Aside from wishing to err on the conservative side, we were also mindful that the very significant compliance costs covering trucking, then present in the US, were largely absent in Australia's unregulated industry. In the US, the Interstate Commerce Commission was responsible for nearly 30 per cent of Weidenbaum's estimate of total compliance cost and had a ratio of compliance to administrative costs of 210:1 (quoted by Tabb, 1980).

On the basis of a tenfold compliance cost, the aggregate annual costs of business regulation in Australia are therefore between \$22 billion and \$48 billion, or 9 per cent to 19 per cent of GDP.

I might add that these costs do not include resources expended in lobbying for preferred treatment — resources that, in view of the stakes, could be very considerable.

### **Some Caveats**

It might be claimed that the methodology used in arriving at these numbers is somewhat slavishly based on US findings in its treatment of compliance costs.

The problem is that, except in the area of the tariff, few Australian regulations have been subjected to economic scrutiny. It is true that studies of the impact of Australia's specific regulations might be expected to yield greater accuracy. But in order to dismiss the numbers generated from (conservatively) applying the US data, it would be necessary to demonstrate that the effect of Australian regulations has been massively different from that of their US counterparts. Where economic analysis has been conducted into Australian regulation, for example in studies of the Two-Airline Policy by Kirby and Forsyth (1981) and Hocking (1982), compliance costs remarkably similar to those of US studies have been found.

A more telling criticism goes to the nature of what these costs mean. As in the case of taxation costs, to which regulation costs are akin, the measured cost is somewhat different from the economic cost. Thus, it would be incorrect to argue that as the gross cost of government amounts to 42 per cent of GDP, this constitutes the magnitude of the economic cost.

All regulations, like taxation and public spending, produce benefits as well as costs, and the net cost position is likely to be much smaller than the gross position. Regulations mean expenditures are switched around the economy. Although this means losses in efficiency, the true economic costs are unlikely to equal the full computed costs of the distortion. This can be illustrated by analysing data on Australian industry protection. Based on 1982-83 data, the Industries Assistance Commission (IAC) estimated that protection confers the equivalent of a \$6 billion subsidy on the manufacturing industry (IAC, 1982, 1985). This amounted to 3.6 per cent of GDP. However, an analysis based on a general equilibrium model of the economy published by the IAC for the same year estimated that the net benefit from a 35 per cent reduction in assistance levels would be an increase in GDP of 0.7 per cent. Interpolated to a 100 per cent reduction this would mean a net benefit of about 1.0 per cent (a straight-line multiplication would exaggerate the figure because the distortions from higher levels of tariffs are greater than those from lower levels). This net benefit would be reduced to the degree that there are sunk costs in some industries, but increased if improved economies of scale were to emerge.

### III. BENEFITS OF ECONOMIC REGULATION

#### **Pro-Competitive Laws**

Pro-competitive laws are a major element of economic regulation. Many are in effect a codification of common law. Others doubtless bring beneficial impacts but are not without their costs. Such laws

- are targeted against monopoly;
- seek to ensure that suppliers proffer adequate information; and
- discourage or outlaw certain marketing practices, like resale price maintenance, which a strong supplier might otherwise choose to pursue.

Pro-competitive laws seek to bring about, or ensure the continuation of, the conditions under which efficiency is best achieved. This has traditionally been viewed as requiring the rivalry of many sellers seeking profitably to meet buyers' needs, and many buyers

competing for products. There are, however numerous examples of regulation that was originally intended (ostensibly) to prevent exploitation being 'captured', either by producers seeking to buttress their positions or by consumers seeking to ensure lower prices than could be justified by costs.

The case for regulation to combat monopoly exploitation is soundest when natural monopolies exist. Baumol's (1982) contestability theory has overturned previous notions of a dominant firm being automatically able to exploit monopoly powers. Where a market is contestable, exploitive behaviour by a dominant firm will quickly attract competitors. At best, laws against collusion or mergers will, in such circumstances, accelerate a process whereby normal market forces eliminate excess profits thus generated. Moreover, changes in technology have eroded the natural monopoly power of many economic entities. Technological developments have greatly eroded much of the monopoly power in telecommunications and postal services. However, few would deny the case for regulation or government ownership on behalf of the community as a whole where duplication of distribution systems, for example through domestic water, electricity and telephone reticulation, would be an extravagance.

Regulations requiring disclosure of information cover matters as varied as labelling requirements for consumer products and the National Companies and Securities Code. Supplying greater details to a wide range of customers about the composition of products or the nature of offers clearly allows better informed choices to be made and in this respect contributes to efficiency.

However, providing information beyond what the seller wishes to provide is not costless. Moreover, requirements to provide information can reduce entrepreneurial initiatives. For example, in areas like corporate takeovers where delays can bring competitive bids, the likelihood of attracting such competition, although of advantage to the seller, will reduce the incentive for buyers to search out potentially profitable situations thereby reducing the reallocation of resources to more productive activities.

Similarly, requiring firms to provide more information than they would otherwise choose, as in the case of processed foodstuffs, limits their ability to tailor their promotional efforts and may entail additional packaging costs. Verification requirements by the authorities and stipulations as to what constitutes a product described as, for example, jam, build further costs and inflexibilities into the system. Such arrangements impede the development of products that might otherwise occur in response to changing market requirements or technological capabilities. Typically, obtaining agreement for a new food standard or for modification of an existing standard takes three to four years and some considerable costs, matters that must adversely affect innovation.

The basis of Australia's pro-competitive regulations is the Trade Practices Act. Part IV of that Act outlaws activities deemed to be anti-competitive. Resale price maintenance is one such activity. By not allowing suppliers to stipulate a price at which their goods may be resold, the government hopes to encourage greater competition within distribution channels. But the case against resale price maintenance is far from conclusive. Because it reduces information cost and encourages larger inventories and before- and after-sale service, resale price maintenance can be a rational strategy of a producer (and is recognised as such in franchise operations like fast foods). It can help producers to better meet consumer needs and be efficient. If it were used to capture unwarranted profits on distribution networks, alternative products and means of distribution would be attracted to the activity.

### **Anti-Competitive Laws**

One type of economic regulation designed to restrain competition, price regulation, has an ignoble history reaching back many millenia. Frequently governments have used price regulation to prevent or alleviate symptoms of their own activities, which have led to unacceptable taxation or to inflation. Benefits to consumers of price ceilings are normally only transitory as market forces undermine their effectiveness. Even if the regulation has a sustained effect in lowering prices, these benefits are progressively overtaken as the distortions lead to inadequate incentives for producers to maintain supply or expand their investment.

Economic regulation of market entry or distribution undoubtedly confers benefits on the individuals or firms who are thereby partly sheltered from competitive pressures. Such sheltering is however likely to bring with it higher costs and a less satisfactory meeting of different quality and end-use requirements than would be the result of open competition.

Leaving aside these clearly specious benefits of competition-restraining regulation, there are five lines of argument put in its favour.

First, it gives incumbents greater certainty against which to plan their future activities, and it offers those incumbents who might have developed a particular market the opportunity to generate adequate rewards before imitators compete away their profit margins. As such it stimulates innovation, especially for activities that by their nature are not patentable. Against this, it is argued that it is difficult to decide who deserves such rewards. Wide application of such rules would lead to economic ossification by denying competition and the stimulus this imposes upon incumbent firms to seek out more cost-effective ways of meeting market demands. The original innovator still has some advantages before imitators cut these back, and the best means of ensuring dynamism is to maintain the stimulus of competition.

Second, it can be argued that, without the restraint of competition, there might be considerable losses to the community where heavy sunk costs have been incurred in a particular activity that would need to be scrapped, with little residual value, if a marginally better facility were introduced by a competitor. It is argued that the community would be better off if the original facility were retained and phased down gradually and the resources required for the new facility applied elsewhere.

Again, the criteria for making such decisions are difficult to define. Moreover the immediate eclipse of one means of production by another marginally superior means is difficult to visualise — the former would respond by reducing its price and gradually being phased out. In a recent paper, Ralph Harris (1986:2) cited goods now generally available in noting the beneficial changes that progress has brought about and said, 'They exemplify the progressions whereby luxuries not available even to privileged minorities a couple of generations back have spread to become the conveniences, even necessities of the masses. Yet every advance was won by displacing old, outmoded forms of production and work'.

A more persuasive reasoning in favour of this case is where regulation has itself generated distortions. In such instances, for example tariffs, a case can be made for removing the distortion gradually to allow resources to be redeployed progressively. Such a case rests on the 'awesome power of the state' having an impact on market forces that is different from the effect of those forces themselves.

A third case for regulation of market entry — and one frequently put by incumbents — is that it prevents consumer losses by disallowing 'fly-by-night' operators. On these grounds, regulation allows greater consumer certainty that the good or service being purchased will be what is being sought. Regulation of this nature is claimed to be necessary in services as diverse as law, medicine, insurance broking and travel agencies. I do not wish to develop the panoply of industry-specific arguments expressed in favour of such regulation, but it is appropriate to observe that there are costs involved in administering such regulations and that their existence restricts the development of novel forms of competition or low-cost entrants. In both cases they are likely to impede efficiency.

Fourth, restraint of competition is often supported to ensure that a full service is offered. 'Cream-skimming' by competitors, i.e. offering only the most profitable areas of service at prices that will take business away from the full-service operator, can undermine extensive cross-subsidies. Telecom sees its \$700m annual cross-subsidy to non-urban users as a benefit, as indeed it is to those enjoying the lower prices. However, it is one paid for by other users and, by raising the costs of urban and interurban traffic, the competitiveness of industry is reduced and distortions are introduced that can only have an adverse impact on efficiency.

Fifth, economic regulation is sometimes justified on the basis of the 'rotten apple' argument. One firm's activities may affect customers' perceptions of other firms. A case in point is quality control in rural exports. It is maintained that without control, poor quality produce from a maverick producer would jeopardise the hard-won reputations of other producers. Although frequent in some primary produce industries, quality verification is rarely seen elsewhere — even where there is considerably more potential capacity to damage customers' health, etc. Quality control of exports is often supported by the industry as a whole, but it is rarely supported if the individual firms are made to pay the cost. When the processed fruit and vegetable industry was made to pay half the costs of Commonwealth inspection, the various firms concerned very quickly came to the conclusion that the benefits they derived from this service were inadequate to justify it. Such quality control may, however, be essential where, as in the case of Australia's beef exports, customers demand it as a condition of purchase.

#### **Other Forms of Economic Regulation**

There are two aspects of economic regulation that fail to fit into either the pro- or anti-competitive categories: first, where there are 'externalities' or benefits from an activity that spill over to the community as a whole; and second, where property rights are impossible to define in such a way that an unregulated competitive industry can contribute to overall economic well-being.

Support for regulation in the form of subsidies to ensure that certain activities are promoted is usually based on multiplier effects accruing to the rest of the community. It is frequently argued that the rewards of the market will, of themselves, be insufficient to promote optimal development (or retention) of a particular industry or activity. However, this case rests on the view that the favoured activity confers greater benefits than the others that must be taxed to support it. Normally this involves moving into the murky waters of winner-picking.

The case for supplementing market rewards does, however, carry some substance with respect to research and development because of the non-patentability of the findings of much research. Where research is patentable, adequate rewards may be reaped by the innovator even though, in most cases, the rewards for the community as a whole will exceed these. However, many discoveries become common property soon after their development, and others are non-patentable because they involve only minor improvements to already patented techniques. Under these circumstances, society is likely to underinvest in innovation, and a strong case for the extension of supplementary support can be made. Australia, like other countries, has various forms of assistance to research and development.

The inability to vest property rights is the rationale behind a considerable body of regulation. In radio and television, it is claimed that because the broadcasting spectrum is limited and there are many competing needs for it, allocation should be by a regulatory agency. However, if we look closely we can see that it would be no more difficult to assign property rights to the broadcasting spectrum than is the case with real estate. Fixing property rights for various parts of the spectrum would allow the price system efficiently to allocate the various uses.

A more convincing case of unownable resources, the regulation of which is unavoidable, is found in the fishing industry. Fish in the ocean are common property and have different values depending upon their location and stage of development. The fact that they migrate and are free makes it very difficult to assign rights over them that optimise national welfare and avoid overfishing. Usually governments have imposed vast regulatory structures to preserve stocks and prevent the taking of young fish. Regulators give rights to certain fishermen, specify times at which fish may be caught, limit boat and net sizes, and so on. Such regulations are certain to give rise to inefficiencies since they cannot cover all contingencies and are likely to be inflexible. A preferable approach is to make use of the price system by levying a tax on each fish caught, consistent with the need to preserve stocks, leaving the various market participants to determine how best to take advantage of the opportunities.

In most cases it is difficult to maintain that economic regulation brings about net benefits. To do so is to argue that governments are in a better position than the atomised community as a whole to sift, sort and organise activities against the masses of needs, productive possibilities and competitive situations. Although this is theoretically possible, the likelihood of information overload, the cumbersomeness of bureaucracies and the divorce of prospective personal gain and loss from the decision process make it unlikely. Empirical evidence of governments having succeeded in picking winners in this manner is extremely scarce.

In light of that, all sorts of regulations become counterproductive: tariffs, subsidies, occupational licensing, shop trading hours, restricted entry into broadcasting and many areas of transport, primary industry marketing organisations, and price restraints on such matters as petroleum products or building rents.

### **Equity and the Role of Economic Regulation**

Some of the rationales for economic regulation are based on equity considerations. Cross-subsidisation appears to be a major justification for much of the economic regulation of transport and communications; it

previously was used to justify the regulation of brokerage commissions and remains at the heart of regulation of corporate takeovers.

Equity considerations of a different sort are behind regulation of rents and of petroleum distribution. In these cases, the regulation is based upon the supposed ability of large sellers to impose an unjust price on smaller, often unorganised clients or franchisees. A moment's reflection, however, casts doubt on the merits of this case. The position of the small businessman vis-à-vis his large supplier is no weaker than that of the consumer vis-à-vis a large retail store. As long as there is competition, the large supplier is constrained by the knowledge that clients can go elsewhere. Alleged unjust treatment meted out on even one small client will cause others to reconsider their own contractual relationships with the supplier, and will render it easier for competitors to dislodge clients from the relationship.

Of relevance and some topicality in this respect is the matter of franchise regulations. Mutual interest is a powerful force for ensuring equitable contractual arrangements in a whole host of franchise relationships, and the government's intervention to strengthen the position of one party can lead to inflexibilities of operation. Making it difficult for a franchiser to remove a poorly performing franchisee or to insist on new operating arrangements in response to perceived market changes will work to the detriment of the parties in general and eventually consumers.

Similarly, rent or tenancy controls, for example in shopping centre leases, while reducing the price the owner insists upon, will lessen the return on the centre and perhaps reduce its aggregate effectiveness as a marketing entity. Common law recourse is available to any leaseholders who considers themselves to have been unfairly treated. Furthermore, the shopping centre owner will face either a concerted revolt or a migration of tenants to other sites if his actions are considered to be arbitrary and against the mutual interests of all the parties.

Equity considerations can generate similar inflexibilities, while failing to meet their objectives, when applied to cross-subsidies of many transport modes. Thus in the case of airlines, the cross-subsidy, if it exists, is from mainly affluent city dwellers to mainly affluent rural dwellers and carries no obvious implications for a more equitable income distribution. In the case of bus transport, the requirement that a successful concessionaire operate a full service is a cross-subsidy from relatively low-income commuter users to relatively low-income off-peak users. Again, there is no obvious improvement in social justice and, as in other cases, there is a diminution of efficiency.

In the market place, needs are met only if they are backed up by ability to pay. Any intervention is likely to affect efficiency adversely. This is equally true of interventions that force suppliers to service unprofitable markets, and of interventions that redistribute money from

people deemed to be able to dispense with some of their income to those deemed worthy of additional support. Every civilised society has shown compassion for the poor and has sought to modify the strict neutrality of the market place. Such measures contribute to the cohesion of the community. But redistribution of income should take place with the understanding that it is likely adversely to affect the mainstream wealth creation process.

Moreover, the distortions generated by the pursuit of equity are generally regarded as less harmful if the redistribution is made in cash terms than if it is made in products and services. Cash allows the recipients to weigh up their competing needs and assign the funds accordingly. Thus, though the poor may wish to travel off-peak in buses at a subsidised price, given the choice, they may prefer to spend such redistributed funds on more or better quality food, housing, etc. Goods are therefore always of lesser value than money. Hence equity is best pursued by taxation and redistribution rather than by economic regulation.

#### **IV. BENEFITS OF SOCIAL REGULATION**

While a forceful case can be made against most forms of economic regulation, the case against many aspects of social regulation is less persuasive.

Social regulation obligates firms to modify their products and inputs but leaves the market to adjust prices accordingly. It therefore brings about higher prices. In Australia it covers such matters as product testing, environmental controls, occupational health and safety, wages and working conditions.

Philosophically, the case for social regulation is underpinned by several factors that the market may not be able to deal with. These are the spillover effects that transactions might have on third parties, the difficulties of obtaining recourse at law for certain damages, and public morality.

Meeting the needs of consumers may impose costs on people not party to the transaction. Compensation for such costs can theoretically be arranged, but there are difficulties in determining whose property rights have been infringed and by how much. Pollution is a case in point. Sulphur or carbon emissions inconvenience those living close to a production facility, but their control may be costly and result in higher prices for the firm's customers. It would theoretically be possible to arrange compensation for those parties disadvantaged by emissions without introducing regulation, but in practice this is difficult.

Regulation can also be justified even when compensation for incidental adverse effects is practicable. Thus, most people in the

community favour laws that limit the amount of time a truck driver may spend at the wheel. The fact that these laws — especially if pushed too far — are often broken is another matter. Laws on driving hours are favoured because of dangers to other road users caused by an over-tired truck driver. It could be argued that the common law, self-preservation, and insurance penalties contribute sufficient incentive for the truck driver to take adequate care, but individuals have different attitudes to risk. Laws on driving hours are intended to forestall the imposition of some individuals' risk profiles on the community as a whole. That said, sometimes this form of social regulation is introduced for inappropriate reasons. An example would be forcing non-unionised or entrepreneurial workers to accept reduced driving hours negotiated as an improvement of conditions by unionised workers who wish to ensure no loss of relative competitiveness.

The inevitable cumbersomeness of legal processes and the often minor inconvenience generated by a spillover to any particular party may cause market failure. Even though the aggregate cost of an activity may be significant, the damages at law for any affected party will frequently not be worth the inconvenience of arranging coalitions of similarly affected parties to prosecute a claim.

Finally, public morality may dictate that supplying certain needs shall not constitute a legitimate business, even where third parties are not obviously affected. Most societies have laws against pornography or the selling of hallucinogenic drugs with this in mind. Most societies also forbid individuals to work for income where there is a high chance of death occurring — for example if a market were available for Russian roulette players, even if the participating individuals considered the reward commensurate with the risk, it would be forbidden. Less extreme activities such as cock-fighting and bear-baiting have long been outlawed in many countries. Such moral grounds for regulation have as their rationale that allowing these activities would undermine deeper ethical values to the detriment of society as a whole.

Moral questions aside, many writers doubt that social regulation is conferring net benefits. In the United States, Hazilla and Kopp (1985) estimate that between 1981 and 1990 environmental quality regulations will have resulted in a reduction of real Gross National Product of 7 per cent. Australia's environmental laws, though different from those of the US, are likely to be no less costly.

As well as substituting improved environmental conditions for lower levels of income, social regulation has different effects on the various classes within the community. While many in higher income brackets and especially among the professional classes choose to place or are able to place a high value on achieving cleaner air and water, this goal might not receive the same priority from other groups. When firms are required to limit emissions and discharges into the atmosphere, they

must inevitably bear costs in excess of what would previously have been incurred. These costs, in the absence of monopoly, must be passed on in higher prices or lower output levels. As Milton and Rose Friedman (1980) point out, higher prices may be an acceptable outcome to the better off who are willing to trade these (or reduced employment) for lower levels of pollution, but they may be less acceptable to others. Whether the outcome is reflected in price or employment terms, pollution control mandated by government is likely to rearrange the various benefits and costs of economic activity in ways that can operate perversely upon equity considerations. Regulations in product safety and occupational health and safety can have the same sorts of perverse effects on equity.

Clearly the community should be fully aware of the attendant costs and benefits before proceeding with social regulation. As with economic regulation, some consideration should be given to the most efficient means of accomplishing the goals of social regulation. Where it can be used, the price mechanism is again the most efficient such means. Thus, if it is considered necessary to reduce pollution levels, rather than making specific means of achieving this mandatory on plants, it is preferable to leave such decisions to the management of plants themselves and apply a tax on excess pollutants. Of even greater merit are procedures that allow plants to 'trade' in pollutants. For example, it costs the chemical industry much more to reduce certain emissions than is the case for the paper and metal industries. The same objectives in terms of cleaner air may be achievable, at lower cost, by measures that allow reduced anti-pollution expenditure in the chemical industry and greater expenditure in metal industries.

It is an unfortunate corollary of the increased complexities of modern economies that income and employment costs of government regulations of certain activities are often inadequately understood. By contrast, the benefits of cleaner air, fewer industrial accidents and improved product safety are readily acknowledged. In part this is because adverse effects may be widely spread; often it is because they focus upon loss of future income rather than on jeopardising existing facilities. With this in mind, those calling for enhanced conditions commonly settle for such enhancements to apply only to new facilities, thereby not threatening the workers in and owners of existing sources of production. Indeed 'grandfathering' facilities in this manner confers a competitive advantage on extant facilities, an advantage that the Chicago School's 'economic theory' of regulation posits as a major cause of regulation.

Commonly, however, those calling for regulation do not believe that significant costs of this type will be passed on in terms of higher prices or reduced levels of employment, sometimes claiming that the regulation will itself bring a beneficial impact in employment terms.

To test these various claims, the Commonwealth now requires Regulation Impact Statements of major new proposals in which the relevant costs and benefits of regulations are compiled and examined. To be undertaken satisfactorily, cost-benefit analyses require the use of an integrated economy-wide model. In practice it is necessary to settle for a somewhat less complex analysis, especially where the effects of the proposed regulations are not capable of being captured by such models.

## V. LABOUR MARKET REGULATIONS

I have been asked to place some special emphasis on labour market regulation. Fifty-seven per cent of the Australian workforce is unionised. This in itself need be no more of an economic distortion than if a similar proportion of employers belong to industry associations. However, where closed shops operate, as they do in a great many activities — including in the professions — most economists would see the resulting monopoly as a possible cause for concern. As with other monopolies, if alternative suppliers can contest the market, then there are considerable limitations on the powers of a labour union or professional body to extract excessive remuneration for its members.

Unlike the professions, which are constrained by codes of ethics and see themselves as working in the interests of their clients, unions in the past have seen their interests as fundamentally antithetical to the goals of the enterprises in which their members work. This can give rise to a considerable potential for inefficiency. That said, restrictive trade practices outcomes from monopolies managed by professional organisations may be no less stifling to competition-driven efficiency than those of union labour monopolies.

The extent to which any single union is able to extract better conditions for its members than is possible under a market solution depends upon the solidarity of its membership and the substitutability of that membership's output. If a group is seeking to bargain an improved position for itself, it is no less legitimate for it to withdraw its labour than it is for a manufacturer to refuse to supply a customer under conditions it regards as inappropriate. However, in the latter case the natural forces of competition limit the degree to which the manufacturer can impose conditions on customers. Where such forces do not operate, it is because government has introduced or permitted impediments to competition or because a natural monopoly exists. Where the power of the manufacturer stems from government regulation, most economists would advocate measures to open up the market to competition. Where it emanates from natural monopoly, government regulation to limit the exploitive capabilities of the monopoly would be one preferred solution.

A dispute between employers and employees is likely to penalise both parties. In addition, some increased costs to third parties are inevitable if a dispute denies them the use of their preferred supply or service source. But where the third party is denied any such supply by the union involved, then the union's power is considerable. Pejorative terms like 'scab' and 'blackleg' are commonly used against those offering to work on terms and conditions that the striking workforce considers to be inappropriate.

Yet the margin between the costs of the 'scab' and the costs of the union supplier is in reality the margin within which remuneration negotiations should take place. To the extent that the union suppliers of labour can, as a result of their familiarity with the work and its requirements, raise their productivity above that of their competing suppliers, their negotiating scope is increased. When unions exert force to prevent manufacturers from taking advantage of alternative supplies or services, it is like the manufacturer refusing the price a customer is offering for his goods, and taking steps to prevent that customer from obtaining similar goods or service from alternative suppliers. In such a case the customer would have recourse to common law (or for that matter the Trade Practices Act).

Any individual union can succeed in extracting improved conditions through its monopoly bargaining strength only at the expense of the community as a whole (unless its employer adversary is already extracting monopoly profits, in which case the union membership is able to share in these). But the workforce as a whole is unable to achieve conditions better than those of a market solution on a sustained basis. Attempts to do so will result in higher prices, lower levels of employment, reduced profits (and hence investment), or a combination of these.

Australia's Arbitration Commission presumably seeks to make decisions that emulate those of a market solution. But it will generate inflexibilities to the degree that it fails in that aim. Incorrect decisions may operate in either direction. Should the Arbitration Commission determine remuneration and working conditions lower than those of the market, the workers remain free to leave for better paid positions, a process that will (gradually) generate increased wages. Should the conditions be determined above those of the market, employers are free to reduce the more marginal aspects of their activities or take their skills and capital into other activities or to the same activity overseas. Such processes will eventually restore equilibrium but, since both parties are likely to have certain sunk costs in the activity, it could take many decades in some cases.

It does appear, however, Robe River aside, that employers rarely seek to overturn the Arbitration Commission's decisions while unions more frequently refuse to abide by them. The Hancock Report rejected

the notion that the Commission is an umpire, noting (10.301) 'an air of resignation abroad that the implementation of sanctions against unions is extremely difficult, if not impossible'. To the extent that this is true, some asymmetry is likely to operate with a bias in favour of remuneration levels above those the market would generate. If wages are set above those of a market determined outcome, a transfer of income takes place. Those with jobs enjoy higher levels of purchasing power at the expense of those who are unable to find employment and, at least initially, at the expense of lower profits and reduced opportunities for profitable investment.

This view rests on the notion that the regulation of wages simply means some natural wages share is reallocated. Examination of the share of wages in Australia's gross non-farm product shows it to have risen from about 61 per cent prior to 1970 to 67 per cent in the mid-1970s, before returning to its longer-term average. The main difference between the beginning and end of the period is that unemployment had risen from under 2 per cent to over 8 per cent.

It oversimplifies matters to talk in terms of immutable shares of GDP without considering changes in taxation and inflation, both of which would affect the various components of GDP. Adjustments to take these matters into account tend to show the wages share still remains somewhat above its long-term level (a greater proportion of those wages is also earned producing non-tradeable public goods and services). Nonetheless, if wage regulation, in whatever form, has simply redistributed the wage share of GDP, there is a transfer from the unemployed to the employed. Some of this would be taxed in order to pay unemployment benefits.

However, this is an unduly static view for two reasons. First, the unemployed are not contributing to national income. If they were employed they would make a positive contribution, though one less than the average given that they are likely to be less productive (or have less appropriate skills than the average). Second, requiring income to be taxed to allow consumption for those who are unemployed causes a drain on savings. The proportion of Australia's national savings to gross domestic product has fallen quite markedly over the past 15 years. This denies Australia resources for investment and hence for future growth in incomes.

Efforts to push the wages share above some normal rate are likely, in this analytical framework, to bring about overconsumption and inadequate savings and investment levels. If the wages share is returned to some longer-term norm, but in the process wage and unemployment levels remain high, production and productivity enhancing savings are being reduced. This view would regard the growth in Australia's income levels as having been very much reduced as a result of the operation of labour market distortions over a prolonged period.

Other analytical frameworks consider unemployment levels to be related neither to the regulation of wages and conditions nor to the ability of trade union monopolies to boost their members' remuneration above some market determined rate; rather, those of this view see a higher degree of frictional unemployment being a major contributor. Most would agree that technological developments and shifting comparative advantage (e.g. through the rise of the newly industrialising countries) has had some effect on the nature of employment. It is however not always clear why such phenomena have had little impact on employment levels in countries like Japan or Sweden but a major effect in countries like Australia, the UK and Spain (not all of which have centrally determined wage systems).

It may also be argued that failure on the part of management and financial intermediaries rationally to seize opportunities has resulted in lower levels of investment or savings than might be expected. If this is true, economic analysis becomes exceedingly difficult.

A centralised system of wage fixation will inevitably lack flexibility and will not be able to cater for individual workplace situations. However, some countries with centralised systems, notably Sweden and Austria, appear to have achieved considerable adaptability, low levels of unemployment and more than satisfactory rates of growth. Many argue that success in these countries (and perhaps also in Australia), together with industrial relations realities, mean that a decentralised market determined system is not necessarily the preferred solution. The merits of their case rest on the view of what constitutes industrial relations realities, how immutable they are, and whether centralised systems can be transformed into mechanisms that generate greater worker/management cooperation to raise efficiency levels.

## VI. CONCLUDING REMARKS

The puissant growth of modern economies is rightly traced back to the effects of the industrial and commercial revolutions on medieval regulation. It was of course a symbiotic process, whereby the resurrection of common law was both a cause and an effect of increased efficiency and flexibility. A rich harvest of higher income levels was reaped by those nations that discarded the lead weights of medieval regulation and benefited from the consequential spur to innovation and increased and more effectively deployed savings. However, even as the residual elements of that regulation were being eradicated, there seemed to be a disposition to replace them with increasing layers of new regulation. This process accelerated in Australia and elsewhere from the late 1950s.

If a growth momentum is to be recaptured, a renewed onslaught on regulation is necessary. For though regulation typically involves both costs and benefits, by interposing itself between producer and consumer in general it brings a diminution of welfare. Where it affects market entry or price flexibility, regulation reduces the speed at which adjustments may take place to changing consumer needs, technological horizons and input costs. Although benefits are possible, from social regulation in particular, a careful analysis of these and any costs is necessary before governments take action.

The Prime Minister used his 1984 address to the Business Council and the two subsequent annual addresses as forums for announcing measures designed to reduce government intrusion in business. Although it would be premature to say that the aggregate level of such intrusion has been wound back, there are many areas where business regulation has been removed or reduced. These include export controls on minerals and farm products, customs procedures, foreign investment controls, several areas of company law, and private hospitals. An extensive review process has been set in train to examine the remaining areas of intrusion that impede trade, with a view to removing or moderating them.

In addition, arrangements have been made, in which the Business Regulation Review Unit plays a major role, to ensure much greater appraisal and review of proposals for new or amended regulations.

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# The Political Economy of Deregulation

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# The Political Economy of Deregulation

*Ian R. Harper*

## I. INTRODUCTION

Following the appearance in 1971 of George Stigler's 'Theory of Economic Regulation', economists began to look at government regulation of private industry with a jaundiced eye. Stigler drew attention to the tendency for government regulation to serve merely as a device for redistributing income in favour of regulated firms. On this basis, he argued that unregulated firms had an incentive to seek regulation and regulated firms a vested interest in maintaining the status quo. Numerous empirical studies have been conducted that attempt to show explicitly how and to what extent the interests of regulated firms are served by regulation (see, for example, Sieper, 1982, and the survey of regulation economics by Pincus and Withers, 1983).

The Stiglerian view challenged what had up to that time been the accepted view of regulation — that it was instituted by a benevolent government solely to serve the public interest. Thus price controls and entry barriers, for example, were seen as means of eliminating cut-throat competition and facilitating the exploitation of economies of scale.

The notion that regulation was a private good supplied by governments in response to demand by firms proved to be a powerful explainer of the persistence and pervasiveness of government regulation. At the same time, however, it held out little hope for reformers who sought to encourage competition by repealing regulations. The private interest of regulated industry and vote-maximising political parties would surely dominate the isolated and politically uncoordinated efforts of would-be reformers. It therefore came as something of a surprise to the profession when democratic governments around the world began to embrace deregulation both in principle and in practice. This seemed to belie the power of vested interests to sustain advantageous arrangements.

The observation of substantial and widespread deregulation has challenged the Stiglerian view. Some commentators, e.g. Keeler (1984), have argued that the 'private interest' theory of regulation associated with Stigler (1971), Posner (1974) and Peltzman (1976) is incapable by itself of explaining the deregulation movement and that some combination of 'private interest' and 'public interest' factors is at work. Others, e.g. Dertthick and Quirk (1985), reject economic explanations of regulation altogether and point to political factors as the underlying causes of deregulation.

This paper adheres to the Stiglerian view and argues that an explanation of deregulation in terms of private interest is possible. The argument is illustrated by reference to the major instance of deregulation in the Australian economy: deregulation of the financial system. An attempt is also made to predict the future course of deregulation in Australia and to indicate ways in which would-be reformers might influence the pace of deregulation.

## II. THE ACHILLES HEEL OF REGULATION

The Stiglerian or 'private interest' theory of regulation stresses the importance of regulations as devices for promoting the private interest of regulated firms. Firms bargain for the imposition of regulations by offering to share the resulting gain with politicians in some suitably discrete form. Thus the supply of regulation in turn serves the private interest of politicians or political parties.

In order for regulations to generate a surplus or profit that can be distributed to the shareholders of the firm and to obliging politicians, they must have the effect of restraining or eliminating competition. Imposition of legislated barriers to entry (e.g. the need for new firms to obtain a licence to compete with existing suppliers) is an effective means of closing an industry and eliminating the possibility of new competition. The imposition by a regulatory authority of price floors and output quotas facilitates the formation of a cartel among existing producers. If new entrants must also abide by the price and output regulations, the industry is insulated from competition both from within and from potential new suppliers.

To the extent that regulations facilitate anti-competitive behaviour by firms in an industry, they underwrite the ability of these firms to earn profit in excess of a normal return on shareholders' funds. The resulting surplus or super-normal profit becomes the glue that cements the interests of the regulated firms and the regulators in favour of the continuing existence of the regulations.

It is not necessary that the pay-off to sympathetic politicians and regulatory authorities be in the form of hard cash. Indeed, there is some

reason to expect this would never be observed given the high penalty attached to graft. Rather it is sufficient that the regulations be seen to promote stability in an industry. The failure of firms is perhaps more of an inconvenience to politicians and regulators than it is to shareholders. To be seen to be presiding over a stable industry or to be responsible for establishing legislation that promotes 'workable competition' is sufficient reward in itself. Industry regulation is an effective means of insulating an industry from the unrestrained entry and exit of firms, which is the *sine qua non* of competition.

In emphasising private interest as the primary factor serving to sustain regulatory regimes, Stigler implicitly provides an explanation of the collapse of such regimes. Regulated firms will seek to abandon regulations when those regulations no longer serve their private interests. Moreover, politicians and regulators will respond to firms' requests for deregulation when it is clear that nothing further is to be gained from the regulations and indeed there is a danger that something substantial may be lost, e.g. stability of the industry, if the regulations are not removed.

In short, a coalition of private interests is just as capable of sustaining anti-competitive regulations as it is of destroying those regulations. The relevant question is, 'What changes in the circumstances of the regulated firms are likely to induce the redirection of their private interest, and that of the regulating authorities, towards deregulation?'

In his celebrated work, *Capitalism, Socialism and Democracy* (1942), Joseph Schumpeter draws attention to the inherently dynamic or evolutionary nature of the capitalist economy.

Capitalism ... is by nature a form or method of economic change and not only never is but never can be stationary. And this evolutionary character of the capitalist process is not merely due to the fact that economic life goes on in a social and natural environment which changes and by its change alters the data of economic action ... The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers' goods, the new methods of production or transportation, the new markets, the new forms of industrial organisation that capitalist enterprise creates. (Schumpeter, 1942:82,83)

Schumpeter's emphasis on the evolutionary nature of capitalism finds clearest expression in his notion of 'creative destruction' (pp.81 ff). The force of new ideas in the form of new products and processes, technological breakthroughs and innovations '... incessantly revolutionises the economic structure from within, incessantly

destroying the old one, incessantly creating a new one' (p.83, emphasis in original). It is through creative destruction that a capitalist economy prevents itself from being overrun by 'monopolistic practices'. Competition in the usual static sense of firms vying for customers in a given market is susceptible to the power of collusion. However, competition 'from the new commodity, the new technology, the new source of supply, the new type of organisation' is much more effective than static competition 'as a bombardment is in comparison with forcing a door' (p.84). It is this latter competitive dynamic that provides 'the powerful lever that in the long run expands output and brings down prices' (p.85).

Competition from outside the market is especially effective in undermining restrictive practices. It is this aspect of Schumpeterian 'creative destruction' that is most relevant in the present context:

both as a fact and as a threat, the impact of new things — new technologies for instance — on the existing structure of an industry considerably reduces the long-run scope and importance of practices that aim, through restricting output, at conserving established positions and at maximising the profits accruing from them. (p.87)

Regulations that have the effect of reducing competition within a market will encourage the emergence of competition for the market, i.e. the development of new products and processes that allow firms outside the existing market to compete for the customers of the regulated firms. The development of new products that are close if not perfect substitutes for those produced by the regulated firms permits de facto entry by new firms into the regulated market. Firms outside the regulated industry have an incentive to develop substitutes for the output of the regulated firms so that they can share (albeit temporarily) in the super-normal profits generated by the regulations.

The advent of new competition in the form of new firms supplying close substitutes for the output of regulated firms erodes the power of the regulations to generate super-normal profits. The power of any monopoly or oligopoly to earn economic rent depends ultimately on the degree of price inelasticity of the demand curve it faces. Price inelasticity of demand is conditioned by the presence or absence of close substitutes for the product in question. The development of new products that substitute closely for the products of the existing monopoly or oligopoly will reduce the degree of price inelasticity of the market demand curve, heightening the sensitivity of consumers to the existing high monopoly/oligopoly price. It may even shift the market demand curve downwards to the left, i.e., result in an absolute reduction in the quantity demanded of the monopolist's/oligopolist's product at

every price. In either case, the capacity of the monopolist/oligopolist to price in excess of average cost and generate super-normal profit is reduced.

The Achilles heel of any restrictive practice, including regulation, is the capacity of the market to generate new products that substitute closely if not perfectly for the products whose output is restricted. This process of substitution is greatly enhanced by the development of new technologies. Technological innovation therefore plays a vital role in the creative destruction of restrictive regulatory practices.

### III. THE RESPONSE OF THE REGULATED FIRMS

Competition from new suppliers outside the regulated industry erodes the protective effect of regulations. The regulations are no longer sufficient to provide regulated firms with above-normal profits. As the protective effect subsides, the constraining effect of the regulations dominates. Regulations are by their nature constraining or restricting devices. This constraining effect of regulations protects regulated firms from competition among themselves — the enemy within. It cannot protect them from the enemy without. Indeed, once new competition begins to eliminate the protective effect of regulation, the regulations themselves become net burdens on the regulated firms, constraining their ability to meet competition from unregulated firms.

It is the increasingly burdensome effect of the regulations on the regulated firms that leads them to call for their removal. In the increasingly competitive environment engendered by new entry of unregulated firms producing close substitutes for the output of regulated firms, the latter must adapt if they are to survive. They now discover that the chains that kept them from competing with one another prevent them from competing with the unregulated firms. If the regulations are not removed, the regulated firms eventually lose the competitive struggle to the new entrants, a prospect that cheers the regulatory authorities no more than it does the regulated firms. The private interests of both the regulated firms and the suppliers of regulation are thus switched from support for the regulations to support for their removal. If the impact of new competition from unregulated suppliers of substitutes is sufficiently severe, deregulation can occur very quickly.

This is precisely what happened in the case of bank regulation in Australia and arguably also in the United States (Derthick and Quirk, 1985:15,25). The details of the Australian experience are canvassed in the next section. The theory also fits remarkably well the case of railroad minimum rate deregulation in the United States (Keeler, 1984; Derthick and Quirk, 1985). The railroad companies had succeeded in obtaining minimum rate regulation (i.e. a price floor) from the Interstate

Commerce Commission (ICC) as a means of preventing competitive rate-cutting among themselves. This system operated successfully and proved quite profitable until the development of long-distance road haulage by truck. The truckers entered the market for long-distance haulage previously dominated by the railroads and began to compete on rates. The railroad companies then discovered that the minimum rate regulation that had eliminated competition among themselves constrained their ability to meet the new rates being offered by the truckers. They made immediate representation to the ICC for the abolition of the minimum rate regulation. Concerned about the impact of truck competition on the profitability of railroad companies, the ICC granted their request and simultaneously imposed regulations on the truckers. These too were subsequently abandoned although not, it seems, with the unanimous approval of the trucking industry (Derthick and Quirk, 1985).

#### IV. DEREGULATION OF THE AUSTRALIAN FINANCIAL SYSTEM

Australia's experience of financial deregulation conforms almost exactly with the pattern predicted by 'private interest' theory (for a more detailed account of financial deregulation in Australia see Harper, 1986). Banks were subject to a variety of regulations controlling new entry to the industry, rates of interest offered on deposits and charged on loans and the composition and rates of growth of their asset portfolios. As a result of the regulations, Australian banks grew to become some of the most profitable in the Western world. At the same time, the industry was exceptionally stable with no new entry for a period of more than 30 years and no failure resulting in the loss of depositors' balances in the history of bank regulation. Both of these outcomes are consistent with private interest theory: the regulations served both the regulated banks and the regulatory authorities.

From the inception of the regulations during the Second World War there had been a gradual emergence of non-bank financial institutions offering financial services in competition with the regulated banks. Some of these institutions were owned by the banks themselves. Until the early 1970s, the growth of the unregulated institutions constituted no threat to the dominance of the banks, particularly since the banks maintained a monopoly of the domestic and international payments systems and continued to enjoy *de jure* liquidity support and *de facto* solvency support from the central bank.

The situation changed dramatically during the decade of the 1970s. The onset of inflation at high and variable rates substantially increased the restrictive impact of the regulations on bank portfolios. The advent

after 1974 of a large public sector borrowing requirement following the substantial increase in the Commonwealth budget deficit added a new source of competition for loanable funds. Most importantly, however, technological developments eroded the market power of the banks by making financial services provided by domestic non-banks and by offshore financial markets increasingly close substitutes for the output of the banks. These included most especially developments based on new communications and data-processing technology.

The result of the enhanced competition from unregulated financial institutions was that the banks began to lose their dominant position in domestic financial markets. This affected not only the attitude of the banks towards the regulations but also, and importantly, the attitude of the regulatory authorities.

The banking system was the fulcrum upon which the regulatory authorities exercised monetary policy. Control of the growth of bank balance sheets was intended to influence the growth of financial activity generally and hence ultimately the growth of the real economy. As the banks progressively lost market share to non-banks and, indeed, to non-intermediated (direct) sources of finance, the monetary authorities began to lose their grip on the growth of the financial system. An important pay-off to the regulatory authorities in regulating the banking system was their ability to determine the rate of growth of the banks over time by manipulating the regulations. As this exercise became increasingly less relevant in the face of the continuing growth of non-bank financing outside the influence of central bank control, the regulatory authorities lost faith in the regulations.

In order to restore their influence over financial markets, the regulatory authorities knew they would have to act to restore the supremacy of the banks and take steps to make prices rather than quantities transmit the impact of monetary policy. Both of these actions required financial deregulation. The need to reverse the declining fortunes of the banks by removing restrictive and burdensome financial regulations forged a common interest between the regulatory authorities and the banks. The power of that common interest, so effective in sustaining financial regulation for more than 30 years, brought about the near complete dismantling of the system within a period of only five years.

There is one further lesson to be drawn from Australia's experience of financial deregulation that has wider ramifications. An obvious response to the emergence of substitutes for the output of the regulated industry is for the regulatory authorities to extend the regulatory net to encompass the substitute suppliers. Both the public interest and private interest theories of regulation would predict this response, the latter theory arguing that the substitute suppliers would themselves approach the regulatory authority to be drawn into the cartel. Again what limits

this response in theory as in practice is the ease with which yet newer substitutes emerge, particularly in forms that are inherently more difficult to regulate.

In the case of Australia's financial system, the means of extending the regulations to include the major non-banks were at hand. Part IV of the Financial Corporations Act 1974 contained all of the legal machinery necessary to extend the powers then exercised by the Reserve Bank over the banking system to encompass the non-banks. This Part of the Act had been enacted by the Parliament but never proclaimed. It therefore remained on the statute books requiring only the signature of the Governor-General to become law.

It is instructive that, given how easily the regulatory net could have been widened, this option was not exercised. One need look no further than submissions by the banks and the monetary authorities to the Campbell Committee for an explanation. Both the banks and the authorities knew that inclusion of the non-banks under the regulations was not a long-run solution to the declining fortunes of the banks. Regulation of the non-banks would merely encourage the substitution of direct financing, including financing through off-shore financial markets, for financing through Australian financial intermediaries. Inclusion of the non-banks would certainly constrain their growth but not to the benefit of the banks. Furthermore, it was simply not possible to extend the regulations to incorporate direct financing (let alone financing through off-shore markets) given the myriad forms such arrangements could take. The only alternative was to release the banks from their constraints. Subsequent experience of substantial re-intermediation testifies to the efficacy of this response.

## V. TELECOMMUNICATIONS — THE NEXT TO GO?

The Australian post and telecommunications industry is virtually monopolised by two statutory authorities, Australia Post and Telecom. In recent years there has been some 'nibbling at the edges' as independent private operators have developed courier services and electronic mail and substitute suppliers of telephone equipment have been allowed to connect their apparatus to the Telecom network. None of these developments is so far advanced as to threaten the dominance of the public monopolies. Yet the technological revolution that has given rise to the emergence of substitutes for traditional postal and telecommunications services is the same revolution that has so recently upturned the financial services industry. The development of new financial products and services facilitated by the technological revolution was instrumental in bringing on financial deregulation. Might not the same happen to post and telecommunications in Australia?

The answer depends on whether substitution becomes so endemic that Australia Post and Telecom themselves petition the government to deregulate. 'Deregulation' in the context of statutory monopolies means abandonment of their 'common carrier' obligations. The industry has traditionally been monopolised in order to facilitate internal cross-subsidisation of loss-making services from profit-making services. This cross-subsidisation has met the political objective of governments to provide a service of a given quality at a common price throughout Australia.

As might be expected, the suppliers of substitute services have invaded the profitable markets only. If the result of this activity is only marginally to reduce the profitability of Australia Post and Telecom in these markets, the emergence of substitutes might well be met by concessions on the part of the monopolies so as not to appear to be hostile to progress. More substantial inroads can be expected to result in calls to protect the existing monopolies by strengthening legislated barriers to entry.

If substitution possibilities become rife, as well they might when private satellite networks enable individuals to bypass the statutory monopolies completely, one would expect a different reaction to emerge. If substitute suppliers are able to force losses on Australia Post and Telecom as surpluses on profitable routes are competed away and loss-making routes become a net burden on the authorities, one would expect Telecom and Australia Post to petition government to release them from their 'common carrier' obligations, i.e. to deregulate them. The monopolies will be quick to point out how their survival is jeopardised by the continuing burden of loss-making services in the absence of protected profitable markets.

The call is likely to find favour with politicians keen to avoid the political embarrassment of continuing substantial losses on the part of Australia Post and Telecom. The alternative of direct subsidies to high cost consumers of postal and telecommunications services will invite less recrimination from taxpayers while placating the potential losers. With the 'common carrier' obligations lifted from their shoulders, Australia Post and Telecom will be free to compete with the substitute suppliers on equal terms, greatly enhancing their prospects for survival (a substantial point in favour of deregulation in the eyes of management and employees). Without the need to cross-subsidise loss-making services, there will no longer be any justification in logic for the statutory authorities to enjoy legal monopolies. Whether or not their monopoly status is formally repealed, however, it will have been rendered redundant in fact by the onslaught of competition from the suppliers of substitute services.

## VI. A REFORMER'S GUIDE TO PROMOTING DEREGULATION

The logic of the argument set forth in this paper is that it is the power of vested interests and not that of ideas that is responsible for deregulation. The private interest theory of regulation points to the power of a coalition of the special interests of regulated firms and regulators to sustain an arrangement advantageous to both groups. The same theory predicts deregulation when that coalition of interests is no longer served but actually harmed by the continuing existence of the regulations. The key to understanding how a powerful force in favour of regulation can become an equally powerful force in favour of deregulation lies in the Schumpeterian notion of 'creative destruction'.

Regulations constrain the actions of regulated firms. So long as these constraints result in above-normal stable profits for regulated firms, the continuation of the regulations is assured. Super-normal profits attract new entrants, however, who compete with the regulated firms by offering new products that, particularly given favourable technological developments, can be very close substitutes for those offered by the regulated firms. Competition from the suppliers of substitutes eliminates the profit-increasing capacity of the regulations, leaving the regulated firms with only the burdens and constraints imposed by the regulations. The inevitable decline of the regulated firms in the face of increasing competition from unregulated firms induces both the regulated firms and their regulators to sue for the abandonment of the regulations. The strength of this coalition assures the success of the suit.

This is very much an economist's perspective on the forces leading to deregulation. It is not often shared by those who are less comfortable with the economist's paradigm. Derthick and Quirk (1985), for example, attempt an entirely political explanation of deregulation and go so far as to say that

the success of procompetitive deregulation cannot be attributed to a change in the configuration of economic interests, nor can it be interpreted as the outcome of bargaining among interest groups ... In our view it is the implausible pretension of the economic theory of politics to extreme simplicity and yet general application that is its fundamental error. (1985:26-7)<sup>1</sup>

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<sup>1</sup> In spite of their general rejection of economic explanations of deregulation, they do concede in the case of US financial deregulation that

The essence of Derthick and Quirk's position is that deregulation was an idea whose time had come. The economics of private interest is supplanted by the politics of ideas. The difficulty with this hypothesis is that it fails to explain why the idea of deregulation caught on when it did and not at some earlier period. The economic explanation links the emergence of pressure for deregulation with the advent of technological change, which results in a rapid upsurge in the appearance of new products closely substitutable for the existing products of the regulated firms.

Given the basic economic motivation for deregulation, one can accept all of the politico-scientific arguments advanced by Derthick and Quirk. The story of how deregulation was marketed to the polity is fascinating and deserves closer study in the Australian context (see Pauly, 1986). However, the politics of ideas are the froth and bubble on the surface of the stream of events. A more plausible explanation of the strength and direction of the current is given by the impact of technological change on vested interests.<sup>2</sup>

The emphasis on private interest as the basic motivating force behind deregulation leads naturally to certain prescriptive conclusions. First, so long as private interests sustain a system of regulations, no amount of proselytising will accomplish reform. Independent academic inquiry into the economic costs of regulation has its place — it will be called on in subsequent political attempts to 'explain' why deregulation is being pursued. Preaching, however, will not put deregulation onto the political agenda. The politics of ideas will help to keep the bandwagon moving but are not strong enough by themselves to start it on its way.

Second, those who seek to bring on regulatory reform must concentrate their efforts on redirecting the private interests of the regulated firms and their regulators. Once this coalition of interests is

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the rise of competition outside the established regulatory framework ... forced the banks and thrifts to accept changes in government policy that they would otherwise have thoroughly resisted. (1985:15)

<sup>2</sup> Not all political scientists reject the importance of economic interests. In his discussion of financial deregulation in the UK under Competition and Credit Control, Moran (1984) argues:

Fashion, academic influence and adversary politics all have something to offer; but the accounts which stress economic interests and bureaucratic policies ... tell us much more. (1984:30)

redirected away from preserving the regulations towards their repeal, the goal of deregulation is within reach.

Schumpeter's notion of 'creative destruction' is the key to achieving this redirection of private interest. Means must be found for encouraging the growth of substitutes for the output of the regulated firms. The regulated firms and the regulators will abandon the regulations only when the burdens outweigh the benefits. The benefits of regulation will fall in proportion to the growth of suppliers operating outside the regulatory net.

This leads to the third prescriptive recommendation: that it is more effective in achieving regulatory reform to campaign for the removal of obstacles to the production of substitutes rather than the regulations themselves. Often resistance to such activity is weaker since it is seen as only peripheral to the main issue of the regulations. And yet successful reform in this area may well initiate a chain reaction that, though small at first, rapidly grows in intensity until it finally bears down on the regulations.

Two examples may help to clarify this point. The Two-Airline Agreement has proven remarkably resilient to the logic of open competition. The argument advanced in this paper predicts that this will continue until competition is enhanced through the emergence of substitutes. The key obstacle to the provision of substitute services is the prohibition of the importation of large passenger aircraft. A related provision that has a similar effect is the denial of the right of Qantas to carry passengers between domestic ports. Focusing on the import ban shifts the ground of debate from the Two-Airline Policy itself to the general issue of trade liberalisation. Resistance to the relaxation of import restrictions may prove weaker than resistance to the repeal of the Two-Airline Agreement. Similarly, an argument that Qantas and, indeed, other international carriers should be allowed to compete for passengers on the main domestic routes will strike some people as reasonable whereas repeal of the Two-Airline Agreement would not. If capacity on the trunk routes was expanded dramatically, as would happen overnight if international carriers were granted entry, the domestic airlines themselves would seek the abandonment of the Two-Airline Agreement along with the rigid fare structure and internal cross-subsidies it entails.

A second example concerns the industrial relations system in Australia. The power of trade unions in this country derives not so much from their extensive coverage of the Australian workforce as from the inability of employers and employees to contract on other than the terms and conditions laid down in court awards. The regulations (including the sole right of a particular union to negotiate on behalf of workers under a particular award) protect the unions from competition supplied by contract labour. Suing for the right of workers to contract

with employers on a mutually advantageous basis outside the award system and strengthening existing provisions against secondary boycotts may well prove more effective in the long term in bringing on labour market deregulation than a direct frontal assault on the Conciliation and Arbitration Commission. Trade union support for the centralised system will soon evaporate if increasing numbers of their members opt to sell their labour in the unregulated sector. A deregulated labour market is not incompatible with an active trade union movement. It is incompatible, however, with centralised wage determination and minimum wage laws.

Derthick and Quirk (1985) conclude their analysis of the politics of deregulation with a paean to the US political system, which as a result of widespread deregulation is seen to be much less prone to the influence of special interest groups than has commonly been supposed. This paper argues that far from denying the power of private interest, deregulation is testimony to its pervasiveness — that in the end, it is vested interests and not ideas that are 'dangerous for good or evil' (Keynes, 1936:384).

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# COMMENTS

## *Wolfgang Kasper*

I am in the happy position of being able to comment on two interesting, informative and relevant papers with which I have no real quarrel. I would therefore like to highlight what struck a particularly responsive chord in both papers, and only then add a few minor quibbles.

Alan Moran's paper illustrates that it is the Leviathan of pervasive and intrusive government which ties down the striving wealth producers with strings of regulation. In doing so, the paper repeatedly makes a point close to my heart — a point I would like to underline more explicitly: Regulation costs much economic growth and many jobs.

The costs of market regulation cannot be demonstrated fully if our reference system is the neo-classical, comparative-static economic textbook model. In that model, given resources are allocated to meet given, predetermined social objectives. In such a system, interventions can normally be presented as merely reallocating resources. In reality, neither resources nor objectives are given. They have to be discovered and developed in a dynamic process — as Adam Smith and the Austrian School have stressed time and again.

Government regulation — like widespread theft in society, as Gordon Tullock (1966-67) has pointed out — imposes long-term dynamic costs. Regulation lowers the rate at which society develops its resources. Regulation inhibits entrepreneurs in uncovering and testing new resources (especially knowledge), and it induces people to engage in otherwise unproductive behaviour.

I find Dr Moran's estimates of the growth costs of regulations entirely convincing. Roughly interpreted and averaged, he estimates that, over the next ten years, business regulation, if retained, will cost us about 1.5 percentage points of economic growth every year. When we approached the question of pervasive regulation in the book *Australia at the Crossroads* from a quite different angle, we estimated that the

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differential in per capita income growth would be 2 percentage points per annum between a regulated mercantilist scenario and a market- and innovation-oriented alternative (Kasper et al., 1980).

Increasingly, the point is made and accepted in Australia and overseas that unregulated, genuine competition has the great advantage of facilitating structural adjustment and economic growth.

I would like to add two further important social functions of genuine competition that Dr Moran does not mention explicitly. First, competition keeps economies flexible and therefore makes it easier for stabilisation policies to avoid inflation, unemployment, and disruptive cyclical swings. Competitive economies can be stabilised by 'soft-touch' monetary policies, whereas rigid, uncompetitive economies tend to suffer from high inflation and high unemployment. (We then speak of high 'natural' rates of unemployment, but there is nothing in the nature of Australia to make unemployment high. Unemployment is man-made and can be cured by man.)

Second, market rivalry has the important function of controlling not only economic but also social and political power. As Stigler and Ian Harper have taught us, much regulation is not just a benevolent reinterpretation of the common law, but is a political response to special pleading from economically powerful groups. Regulations create their own client lobbies, which then perpetuate 'their' regulation, because that regulation has become a valuable property. The sordid history of tariffs and labour market regulations in Australia illustrates this. Australian protection has shifted much worthwhile effort from the task of raising productivity to kleptocratic lobbying. No wonder that we transfer \$6 billion annually to featherbedded manufacturers! The public at large now seems increasingly aware of the abuses of power by regulated groups, possibly thanks to the efforts by the Hawke Government to perfect the mercantilist, corporate state by such devices as summit conferences, a proliferation of industry councils, and the influence of unions on government policy.

To safeguard the three important social roles of genuine competitiveness — economic growth, cyclical flexibility and stability, and the control of power-concentrations — we have to accept certain types of economic and social regulations. But I would have liked Dr Moran to be more clearly critical of (a) economic regulations that ration certain scarce goods, because regulations tend to perpetuate scarcity, and (b) regulations that foster economies of scale, because we normally observe that technical scale economies and technical efficiency are promoted by government interventions and monopolies, but that genuine economic efficiency suffers in the long run.

Some social regulations applying to health and safety and the environment do have to be accepted. But many of the existing regulations of this kind are really only a smokescreen for redistribution

in favour of powerful groups. And on no account can economic regulation be justified by reference to 'social equity'. The evidence, in Australia and overseas, shows that such regulation either succeeds, but leads only to equal poverty, or fails, leading to greater social inequality. I agree with Dr Moran that cash transfers are a more effective means of promoting equity. The only definition of equity that is compatible with growth is equality of opportunity. Many regulations grossly violate this, such as minimum wage regulations and business licences.

One quibble I have is the case with which Dr Moran cites 'natural monopolies'. I know of very, very few monopolies that are not propped up by government intervention. In the longer run and in a dynamic world with innovating entrepreneurs, it is government protection that keeps monopolies alive, because regulation protects what Dr Harper so nicely calls the 'Achilles heel' of monopolistic suppliers.

Where there are great costs of duplication, e.g. in the rail or Telecom network, public ownership or government regulation tends to facilitate what I call the 'horizontal and vertical contagion of monopoly', namely that government-protected monopolies use their power to spread monopolising influences vertically and horizontally into adjoining markets to get more secure protection for their initial monopoly.

Monopolies are frequently successful in excluding competitive rivalry in adjoining areas, where there is no economic or social justification for excluding competition. Why should private competitors not run trains on their own account on a monopoly rail net? Why should we not have competing air terminals alongside government monopoly runways?

A final quibble I have is with Dr Moran's ready acceptance that research and development merit intervention. By now, the science-driven linear model of innovation has been widely rejected in the literature, because what matters for most innovation is the dispersed, market-oriented commercial knowledge that no single interventionist could ever hope to possess and that only the decentralised search in the market place can help to uncover (Garnicot, 1987). In Australia, we are not short of new ideas; what we lack is the demand for them, since regulation reduces the incentives to innovate.

I like without reservation Dr Harper's Schumpeterian thumbnail sketch of economic activity as an evolutionary, dynamic process. Capitalism, like a bike rider, can perform only when it keeps moving forward. I also share Ian's view that outsider competition, or the threat of it, is most of the time a sufficient condition to make oligopolistic competition fulfil the three social roles I enumerated earlier.

I agree wholeheartedly with Dr Harper's argument that we have to put together conditions of interests in favour of reform. We have to make the organised pressure groups share the common long-term interest in market rivalry. Alliances of pressure group interests can often be

changed by pulling out certain linchpins that hold unholy coalitions together. Thus, I have always considered the tariff the linchpin that has kept counter-productive worker-capitalist alliances together in Australian manufacturing.

However, I disagree with his dismissal of the role of the economist as a preacher. The ideas of economists greatly help the members of emerging coalitions to define their place and to see where their long-term interests lie. The economist-preacher can spell out long-term objectives and identify inconsistencies in the positions held by various groups. He can give warnings of potential accidents, and when the accidents happen they enhance the credibility of his ideas.

I myself had a valuable object lesson in the power of ideas over short-sighted interests when I was part of the 'Burginstock Group', which Milton Friedman and Fritz Machlup gathered together in the late 1960s to explore the rationale of flexible exchange rates (Halm, 1970). Initially, we were confronted with hundreds of substantial, practical objections from those practical men with open and disguised interests in exchange-rate fixing. But, in a long process of rational debate, the idea that a free market for foreign exchange might solve many problems became more plausible and interest groups changed because certain clever people saw new profit in the rational solution.

Traumatic experience is an important auxiliary teacher, but think-tanks propagating rational ideas have frequently been the real catalysts of change, with the vested interests getting into the act several years afterwards. Therefore I shall continue to side with the great French liberal Voltaire, who asked on his deathbed, with great Gallic charm and elegance, 'can there be anything more splendid than to set the whole world in commotion by a few arguments' (Martin, 1962:122).

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## DISCUSSION

**Ray Evans (Western Mining Corporation):** In his excellent paper Dr Moran favoured regulation or government ownership to avoid duplication of distribution systems (e.g. water supply, electricity, telephones). Earlier this year in Lubbock, Texas, I saw two competing sets of electricity wires running down the street, and was assured by the operators that the citizens of Lubbock receive cheaper electricity than their neighbours in adjacent towns. I was told it isn't even necessary to have separate sets of wires to have competition, since rival suppliers can enter common carrier agreements but compete for the sale of the electricity itself. Is there nowadays any natural monopoly argument for regulation in the case of reticulation systems?

**Alan Moran:** While there can be common carrier arrangements, I'm not sure that that's very different from a regulation. Where in-town reticulation systems involve duplication they are conventionally believed to be wasteful, and I can think of many reasons why this should be so, regardless of Lubbock's low electricity charges. It's certainly news to me, and no doubt to many other people here, that there can be duplication of power lines within towns.

In response to Wolfgang Kasper's comments, I should say that I didn't intend to imply that rationing of scarce supplies or capturing economies of scale were legitimate grounds for regulation, or that there were many genuine cases of natural monopoly.

**Cliff Walsh (University of Adelaide):** Dr Harper is surely right in believing that much of the pressure for deregulation is coming from technological change. However, a good deal of new regulation might also be the result of technological change. Was airline deregulation in the USA a result of technological change, or was it caused by some interest coalition? As for telecommunications, it might be quite difficult for deregulation to proceed in this area when Ausat, the only alternative source of technology, is itself 25 per cent owned by Telecom Australia.

**Ian Harper:** Certainly, a firm that has an interest in breaking down a club may also have an interest in joining that club subsequently. For example, East-West Airlines' interest lies not in ending the Two-Airline Agreement but in turning it into a Three-Airline Agreement. But our experience of financial deregulation is more encouraging. The means for extending existing bank regulations to cover the non-banks were to

hand, on the statute books. But it's notable that none of the interest groups argued for that to be done. I believe this was because the extent of substitution did not stop with the non-bank financial institutions. The biggest threat of substitution came from the direct financiers and the off-shore financial centres. The banks, the non-banks, and the Reserve Bank recognised that they would lose from extended regulation, and therefore pressed for complete deregulation.

I haven't tested my theory on the case of airline deregulation in the USA, but if I were to do so I would look at what was happening to the production of substitutes, both by airlines outside the regulated system, and by other forms of transport such as high-speed trains and buses.

I'm much less pessimistic than Professor Walsh on telecommunications deregulation. As I understand it, we may eventually be able to buy the telecommunications services (both domestic and international) of American and other overseas satellite operators, completely independently of the existing government-owned monopolies. With that degree of substitutability, it need not matter how much of Aussat is owned by Telecom.

**Patrick Minford (University of Liverpool):** Can we explain why the Australian industrial arbitration system has been captured by the trade unions rather than the employers? Might there not have been a stand-off?

**Moran:** I'm not sure I can give a complete explanation. But one reason is that the unions' monopoly power is greater than that of the employers. Another is the influence of the idea of social justice, which has been a dominant idea in Australia since the 1950s.

**Minford:** On the ideas vs. vested interests issue, what we need is a theory of why ideas are important to match Dr Harper's theory of why interests are important. Public choice has done a disservice in suggesting that rational voters cannot be mobilised because their interests are so dispersed. But the role of politicians is to aggregate the preferences of individual voters. If voters are rational and politicians are good at marketing, they can turn an idea into an aggregator of preferences. Politicians who have done this successfully include William Gladstone, who marketed Adam Smith's ideas and turned them into practical policies; Ronald Reagan with his recent tax reform; and Margaret Thatcher with trade union reform. This political aggregation process gives a role to both politicians and ideas.

**Harper:** I must take Wolfgang Kasper's advice and read some Voltaire. I've obviously spent too much time reading Machiavelli.

# **'Privatisation' — A Relevant Word for Australia?**

*Chris Trengove*

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# 'Privatisation' — A Relevant Word for Australia?

*Chris Trengove*

## I. INTRODUCTION

'Privatisation' is rapidly becoming a tired old word, and also a rather overworked area of study for economists and other social scientists. Journals and conference programs are now filled with contributions on the subject and privatisation — or at least its analysis — is fast becoming a major invisible export for the United Kingdom, with a steady stream of visiting (and visible) 'experts' providing their view of the process.

Faced with this burgeoning activity, the approach adopted in this paper is somewhat eclectic. A comprehensive treatment of the economic side of the subject can be found in the recent review article by Domberger and Piggot (1986), and a more ample consideration of the successes and failures of privatisation in the UK in the article by Kay and Thompson (1986). I will make some observations in both these areas but do not pretend to cover the field as thoroughly as those authors. Instead I focus on what might be thought of as the political economy of privatisation, with specific attention to the lessons the UK experience may hold for Australia.

I commence with a brief discussion of one of the more curious facts about privatisation as an actively pursued policy — the extent to which it was unheard of until quite recent times. I then go on to consider what might be suitable priorities for privatisation in Australia, and how these compare with the industries the British government has, and so far has not, been able to denationalise. I then look at some details of the UK experience with privatisation, before concluding with a few comments on the fruitfulness of the approach in Australia.

## II. THE BACKGROUND TO PRIVATISATION

When assessing the potential for privatisation in Australia it is worth pausing for a moment to recall the predicament of the Opposition headed by Mrs Margaret Thatcher in 1978 in the UK. The previous experiment with Tory government, under the leadership of Edward Heath, ended disastrously in 1974. The long coalminers' strike, terminated by the final capitulation of the Heath Government, paved the way for the return to power of a less confrontationalist Labour regime.

Given this history, it seems fair to argue that Tory strategists planning for a possible return to power identified the likely sources of future difficulties as (a) nationalised industries; (b) trade unions; and (c) trade unions in nationalised industries.

In May of 1978, during the period in which the party was attempting to firm up its manifesto for the approaching general election, *The Economist* published a leaked version of a Conservative Party research report produced under the auspices of Nicholas Ridley, who was destined to become the Transport Minister. On the question of trade union power, the report identified those industries (mainly nationalised) where it considered it more or less wise for a future Tory government to attempt to withstand strike action on the part of trade unions. In particular, it recommended a number of steps (accumulation of stockpiles, conversion of power stations to joint coal/oil operation, etc.) that ought to be taken in preparation for the possibility of another coalminers' strike.

As for reform of Britain's nationalised industries themselves, the report had plenty to say. The principal recommendation was for stringent application of rate of return requirements, with failing managements subject to dismissal. Little further control, such as that over prices or other policy decisions, was seen as warranted, and creation of supervisory boards of management, responsible for the hiring and firing of managers, was suggested. What did the researchers think of the potential for removing these institutions from the public sector?

The group considered the scope for denationalisation. It believed that it would be easier, and more permanent, to fragment the industries rather than try to sell off whole corporations. It concluded there was least opportunity for this in the 'true utilities' (gas, electricity, railways, water, ports and telephones). The greatest opportunities are in coal, shipbuilding, docks, airports, motor car manufacturing, buses and freight. Specific proposals: (a) form worker co-operatives at coal pits wherever possible; (b) separate ports, and either sell them off or make them into worker co-operatives; (c) make each airport independent and either sell it or hand it over

to local authorities; (d) the assets of the British North Sea Oil Corporation should be sold, preferably to the public at a 50 per cent discount on value with a maximum holding prescribed for any individual. (*The Economist*, May 27, 1978, pp.21,22)

The research group also had some suggestions for dealing with the product market aspect of the nationalised industry problem.

The only legislation that the Ridley report proposes (and itself refers to as 'a nasty little bill') would be to end statutory monopolies in the public sector. This bill would: (a) transfer licensing of private coal mines from the National Coal Board to the minister and restrict conditions of licence to safety considerations only. Coal royalties would be transferred from the NCB to the state; (b) give private generators of electricity the right to sell to the grid; (c) split letter-post from telecommunications and end the telecommunications monopoly at the subscriber's 'front door'; (d) remove the minister's power to stop private sector investment in steel plant. (pp.21,22)

The early years of the Thatcher Government saw a number of these pro-competitive measures acted upon. A new Electricity Act was passed, removing the statutory monopoly of the Central Electricity Generating Board (CEGB) over the generation of electricity. Nineteen eighty also saw the passage of the Transport Act, allowing free entry into express coach services and removing the power of the Traffic Commissioners to control fares and other conditions of service. In communications, the first step was the commissioning of the Beesley report on the commercial uses of the British Telecom network (i.e. resale). This was followed by legislation in 1981 separating the postal and telecommunications services and introducing a number of liberalisations (though not all those recommended by Beesley) into the supply of telecommunications services.

The same period in Australia saw a number of initiatives not dissimilarly related to the possibility of liberalising various statutory monopolies. Two major government inquiries, the Davidson Inquiry into Telecommunications Services in Australia and the Bradley Inquiry into the Monopoly Position of the Australian Postal Commission, were explicitly directed at questions of the extent of competition to be allowed. On the issue of the ownership of Australia Post and Telecom they were largely silent. At the State level, considerable attention was paid to the public sector domination of the electricity industry. Possible introduction of private generators was toyed with in a number of States, and minor liberalisations were achieved in areas such as co-generation.

This emphasis on competition and not outright sale in part reflected the greater ease of making a convincing case for liberalisation, as against the ideological taint often associated with the notion of denationalisation.

In all this debate, suggestions that the State-owned utilities in question should actually be sold were placed very much second to the considerations of amplifying consumer choice through the introduction of product market competition. Specific attention to the problem of public ownership, where it was advocated, focused on the basis of its interrelationship with the question of competition. Littlechild (1981), for example, in a fairly sweeping set of proposals for nationalised industries, entitled 'Ten Steps to Denationalisation' (not yet 'Privatisation'), suggested that a suitable policy would be one that

- (a) divides the larger nationalised industries into more manageable components;
- (b) encourages competition wherever this is feasible; and
- (c) transfers to private ownership those parts of the industry where there are no significant problems associated with monopoly or the wider public interest — in short, not complete and immediate denationalisation, but a significant movement towards denationalisation. (p.14)

Very much in keeping with this philosophy, Littlechild observed that 'what the Post Office needs is an imaginative asset stripper'. His suggestion for dealing with British Telecom is worth quoting in full.

- (a) Divide British Telecom into five subsidiaries: Terminal Equipment, Network Services, International Circuits, Domestic Network, and Local Distribution, with a view ultimately to selling the first three.
- (b) Allow unrestricted competition in all areas. (p.18)

Five years on, the situation in this particular industry is as follows. British Telecom remains as a single entity, but is organised into five operating divisions. These are BT Enterprises (supplying customer apparatus), Development and Procurement, BT International, National Networks, and Local Communications Services. The entire venture, British Telecommunications plc, is 50.2 per cent owned by the private sector, the remaining ordinary shares, together with a Special Share, being retained by Her Majesty's Government. Rather than 'unrestricted competition' being the norm, operators of telecommunications networks must be licensed. Current public network licence holders are British Telecom, Mercury and Kingston-upon-Hull City Council, and it is the government's intention not to license new networks, either domestic or

international, before November 1990. Simple resale of capacity is prohibited at least until July 1989.

The outcome in telecommunications differs dramatically from that envisaged in the leaked 1978 strategy paper, which ruled out denationalisation of telecommunications (a 'true utility'), and also differs substantially from that argued for by the advocates of greater competition in the industry. Yet the Conservative government would undoubtedly view the entire episode as one of its major successes — in fact (so far) the crowning achievement of what has come to be regarded as its 'policy of privatisation'.

In privatisation the Tories appear to have found a way of rendering the concept of denationalisation politically acceptable. The use of the word has now been expanded far beyond the arena of the major nationalised industries to encompass almost any measure that involves expansion of decentralised and individual, as against political and bureaucratic, control and decision making. At least four major strands of the policy have been identified by various commentators.

- (1) Increased use of user charges.
- (2) Contracting out of services to the private sector, the most notable examples being the cleaning of hospitals and refuse collection.
- (3) Sale of hitherto state-owned assets, ranging from the sale of council houses to their occupants to the denationalisation of large industries.
- (4) Facilitation of competition with public sector (and ex-public sector) institutions.

The range of privatisation activity that might fall under one or other of these headings would virtually exhaust the entire subject matter of this volume. For example, increased use of user charges could cover initiatives ranging from the raising of National Health Service prescription charges, to the wholesale privatisation of the health function.

In this paper I am content to confine myself to those areas of privatisation dealing with nationalised industries. While the current British government certainly finds it to its advantage to link, in ideological fashion, all privatisation measures, in the hope of strengthening the case for any particular one, it is fair to say that the overwhelming attention, both in the UK and elsewhere, has been on the policy of denationalisation. For the remainder of the paper I will consider just what the UK government has and (at least so far) has not been able to get away with in this field, and the relevance of those initiatives for future Australian governments.

### III. PRIVATISATION PRIORITIES

To facilitate this comparison, I shall borrow the device utilised by Beesley and Littlechild (1983) (and also Beesley and Gist, 1984) to analyse the potential and priorities for privatisation. These authors argued that such priorities should be drawn up on the basis of the aggregate benefit that privatisation of an industry would bring to consumers, rather than assessed in terms of the diffuse set of other objectives often lumped together under the heading 'public interest'. Benefits to consumers result if privatisation measures lead to greater efficiency of operation and increased innovation. Benefits can then accrue, either directly through lower prices and better products in the industry in question, or indirectly through lower taxes (greater disposable incomes) for consumers in general made possible from reduced levels of subsidy.

Beesley and Littlechild then argued that, other things equal, privatisation benefits were likely to be greater (a) the bigger the industry; (b) the more competitive the industry once privatised; and (c) the less touched the industry had been by severe remedial action while in the public sector.

Candidates for privatisation were then classified in terms of both their 'supply' and 'demand' prospects. Demand prospects were considered as either 'good' or 'bad', depending on whether the long-term trends appeared to be for expansion or contraction. Supply conditions were divided into headings of 'single' or 'multiple', depending on the degree to which technological considerations appeared to indicate 'natural' monopoly in the industry. The authors' judgment as to the appropriate classification of the major nationalised industries appears in Figure 1 (from Beesley and Littlechild, 1983:12).

According to this classification, many of the 'traditional' privatisation candidates — the nationalised manufacturing industries — are to be found in quadrant D. They display dubious long-term demand prospects and are likely to be subject to substantial competition, if not from home then from rivals abroad. Beesley and Littlechild, however, suggested that these industries were not the highest priorities on the privatisation 'hit list'. First, the competitive nature of the industries in which they already operated meant that consumers of their products had little more to gain from improvements in efficiency. Second, many of these industries (partly because of competitive pressures) had been subjected to substantial restructuring in recent times (British Steel's workforce was cut by 38 per cent between 1980 and 1983, British Leyland's by 31 per cent, etc.), suggesting that the scope for further private sector reorganisation would be correspondingly limited.

Figure 1  
 Classification of UK Nationalised Industries Post-Privatisation

		Demand Prospects	
		Good	Bad
Supply Prospects	Single	<b>A</b> Electricity distribution (Area Boards & Grid) Telecoms (local) Gas distribution Airports	<b>B</b> Rail Post (or possibly C7) Waterways
	Multiple	<b>C</b> CEGB (excl Grid) Telecoms (excl local) Gas production Coal British Airways	<b>D</b> Steel BL Rolls-Royce Shipbuilding Buses

The authors' own list of top priorities were the Central Electricity Generating Board (excluding the grid), British Telecom, the National Coal Board, British Rail and the Post Office. The first three of these appear in quadrant C, with good long-term demand prospects and potential for substantial competition in supply. Furthermore, they are currently organised on a monopoly basis, suggesting scope for consumer benefits if competition is introduced as part of the privatisation package. British Airways, on the other hand, was not so important, given its substantial recent restructuring (albeit in preparation for privatisation) and the greater level of competition in the aviation industry (particularly domestically). Somewhat surprisingly, British Rail and the Post Office were included despite poor long-term demand prospects and a basically monopolistic (though perhaps not for the Post Office) supply structure. The authors considered these two industries to be an 'asset stripper's paradise'. While profitability was poor in their traditional areas of operation, they controlled a stock of assets (especially land) with many potentially more valuable uses. Profits from converting some of these assets away from the old line of business could even be used to fund the minimum levels of service deemed socially desirable.

Before proceeding to a discussion of how this list of priorities compares to what the Thatcher Government has been able to achieve in the way of privatisation, I shall attempt a similar classification for

Australia's public sector industries. A list of the main ones, ordered in terms of turnover, is presented in Table 1.

The first observation that one might make, comparing this list to the range of UK nationalised industries, is the relative lack of publicly-owned manufacturing industries in Australia. This is balanced, though, by a penchant for public sector financial institutions, such as the Commonwealth Bank and the State banks. To these one can then add the various State insurance offices and the publicly-owned totalisators. My own classification of the demand and supply prospects for these firms, if privatised, appears in Figure 2.

The traditional utilities — electricity, gas, communications and transport — have been classified much as for the UK. The local distribution networks for telecommunications and electricity have been left in the monopoly region, but the remainder of these industries ought to be capable of significant degrees of competition. Transport is also classified along similar lines, with the railways appearing in quadrant B and airlines in quadrant C. Note, however, that in Australia we also have a government-owned shipping line, ANL, and it seems fair to place it in quadrant D. The financial institutions all appear in quadrant C, with good prospects for competition and growth.

It is in the assessment of the priorities for privatisation that we may find some differences between Australia and the UK. Of the industries in quadrant C for the UK, British Airways was argued to be less of a priority, in part because of its recent restructuring and in part because of the fairly competitive nature of most of the markets in which it competes. The same cannot be said for Australia's domestic aviation industry, where what ought to be a highly competitive industry in fact remains tightly regulated. Australian Airlines is successful in holding its head above water in the duopolistic environment within which it operates, but whether it could do so were the competition a little tougher — given its high manning levels — is another question. Measures dealing simultaneously with the Two-Airline Policy and the public ownership of Australian Airlines therefore remain a high priority. Similar benefits are in prospect for consumers through privatisation measures — particularly those that erode some of the artificial barriers between markets — dealing with international aviation.

If there is an Australian counterpart to the nationalised UK manufacturing industries, perhaps it is ANL. It is placed in a highly competitive industry, but one that does not seem to share the medium-term growth prospects of aviation. ANL's financial difficulties have been accompanied by an inability to prevent substitution towards competing alternatives, and a reluctance to restructure to the extent that would no doubt be called for under private ownership. The preferred response should be one of concentrating on areas of comparative advantage and trimming back uncompetitive operations. Privatisation in

Table 1  
Major Australian Public Enterprises, 1984-5

	Government	Turnover (\$mill)	Workforce (000s)
Telecom Australia	AUS	4765	93.3
Electricity Commission	NSW	1859	11.0
SECV	VIC	1621	22.5
Commonwealth Bank	AUS	1607(a)	36.9
Qantas	AUS	1574	11.7
State Rail Authority	NSW	1439(b)	41.4
Australia Post	AUS	1211	37.0
Old Electricity Commission	QLD	1199	5.2
Sydney County Council	NSW	1036	7.4
Queensland Railways	QLD	872	25.7
MWSDB	NSW	763	12.8
Australian Airlines	AUS	758	8.7
Metropolitan Transit Authority	VIC	628(b)	12.6
Gas and Fuel Corporation	VIC	612	5.5
State Transport Authority	VIC	610(b)	21.6
ANL	AUS	601	3.3
Electricity Trust	SA	554	5.6
MMBW	VIC	517	7.7
OTC	AUS	412	2.3
State Bank	VIC	389(a)	7.8
ANR	AUS	351(b)	9.8
Westrail	WA	313(b)	7.1
Maritime Services Bd	NSW	264	3.3
State Bank	NSW	246(a)	5.8
Urban Transit Authority	NSW	239	6.6
Hydro-Electric Commission	TAS	238	5.2
Health Insurance Commission	AUS	146(c)	4.2
ACT Electricity Authority	AUS	122	0.9
Snowy Mountains HEA	AUS	108	0.7
Government Insurance Office	NSW	76(c)	1.7
Pipeline Authority	AUS	56	0.1

Notes: (a) Interest margin plus other income. (b) Operating expenses plus finance charges; operating revenue was \$939 million (State Rail Authority of NSW), \$193 million (Metropolitan Transit Authority), \$270 million (State Transport Authority of Victoria), \$258 million (Westrail) and \$253 million (ANR). (c) Expenses of management.

Source: Annual reports

Figure 2  
**Classification of Public Sector Industries  
 Post-Privatisation**

		<i>Demand Prospects</i>	
		Good	Bad
<i>Supply Prospects</i>	Single	<b>A</b> Electricity Sydney County Council Other local dist. Water MWSDB MMBW Other water boards Gas GFC Other gas dist. Ports and harbours Maritime Services Bd Other port authorities	<b>B</b> Transport State Rail Authorities ANR Australia Post
	Multiple	<b>C</b> Telecommunications Telecom (except local) OTC AUSSAT Electricity Eloom (except grid) SECV (except grid) OEC (except grid) Other generation Finance Commonwealth Bank State banks State insurance offices Health Insurance Comm Transport Qantas Australian Airlines	<b>D</b> Transport ANL Local buses, etc.

this industry ought to enable some of these hard decisions to be taken, to the benefit of consumers.

As in the UK, privatisation of telecommunications remains a high priority. The situation differs in that Australia now possesses three distinct entities — Telecom, OTC and Aussat — as against one in British Telecom. These are presently confined to separate market segments, leaving the industry in an unnecessarily monopolistic state. Similarly, the State-owned electricity utilities could well do with some competition in the form of private power generation. As in the UK the preferred direction would probably be (at least in the larger States) separation of the grid from the generation side of the business, facilitation of entry into generation, and sale of existing power stations to the private sector. Although the transmission distances are larger than those in the UK, separate ownership of the grid would enable decisions on interconnection with other States to be taken with less reference to present institutional constraints.

As for the State-owned financial institutions, we can distinguish two distinct market segments. First, State and national banks have long been a feature of the Australian economy, and they have generally existed on a roughly equal footing to their private sector counterparts. While there is evidence to suggest that their competitive position has at times been maintained with some taxpayer assistance, it is probably safe to say that the distortion is not as great as in other areas, and that privatisation here is not one of the higher priorities. Certainly, sale of State banks, within an otherwise quite competitive financial sector, could easily be painted as a purely 'ideological' move by political opponents. Whether this remains the case in the presence of increased foreign competition is something that will have to be monitored.

The same cannot be said of the second major area of financial involvement, namely insurance. This sector is currently one of the major ongoing areas of nationalisation, and it is potentially a highly competitive industry. A true program of privatisation would therefore attach a high priority to (1) halting the further moves towards nationalisation of this industry, and (2) removing the monopoly lines of business from the government-owned insurers.

#### IV. UK PRIVATISATIONS

What does the UK experience tell us about the chances of successfully privatising nationalised industries? The major industries privatised to date are listed in Table 2 and some of the proposed future privatisations in Table 3.

Comparing Tables 2 and 3 with the list of priorities set out by Beesley and Littlechild we see that, to date, only British Telecom ranks

particularly highly. As far as major economic impact is concerned, the privatisation program has only just begun. The early privatisations are dominated by the sale of a number of manufacturing and petroleum concerns operating in reasonably competitive industries. In many cases one wonders why the government became involved in these industries in the first place — at least for the most part their sale has raised few questions as to the need to ensure against abuse of monopoly power, in either the product or capital market.

Table 2  
Major UK Privatisations to Date

	Gross proceeds (£mill)	Dates of sale
British Petroleum	855	1979, 1983
British Aerospace	699	1981, 1985
Cable and Wireless	499	1981, 1983
Britoil	999	1982, 1985
Amersham International	63	1982
Associated British Ports	97	1983, 1984
Enterprise Oil	392	1984
Jaguar	294	1984
British Telecom	3863	1984

Table 3  
Prospective UK Privatisations

	Proceeds (£mill)	Comments
British Gas	10000 ?	Regulation to be introduced
British Airways	1000 ?	—
British Airports Authority	?	To be sold intact
National Bus Company	?	Sold in pieces?
Thames Water Authority	1000 ?	—

Also, the list in Table 2 is mostly made up of firms with fairly good prospects. The Thatcher Government has first sold off the industries (BP, Cable and Wireless, Jaguar, etc.) that were 'ready' for privatisation, in that they were already reasonably profitable, and has

delayed the privatisation of other firms (British Airways, Rolls Royce, etc.) until their balance sheets improve.

If one adheres to the logic of the Beesley-Littlechild arguments for privatisation, this sort of preparation is unnecessary. One of the main benefits to be achieved from privatisation is that private ownership provides the stimulus to restructure industries that, in the public sector, have been allowed to drift into areas of inefficient resource use. It is also argued that this restructuring will be better undertaken under private than under public ownership. The firm should yield no more, in terms of privatisation revenues, if the unprofitable lines of business are terminated before privatisation, than if it is sold as is, the assumption being that this restructuring will take place anyway.

Indeed, the only way that revenues can be increased is via the obviously self-defeating but much utilised device of having the public purse incur the restructuring expenses (redundancy payments, write-offs of debt and pension liabilities, etc.). Nevertheless, there seems to be something in the political process that militates against denationalisation followed closely by asset stripping. The end result in the UK has been a determination to restructure nationalised industries, to make them 'fit' to be sold — a process that, paradoxically, ends up removing a good part of the rationale for the privatisation itself.

## V. FINANCIAL IMPLICATIONS OF PRIVATISATION

Proceeds from privatisation, up until 1983–84, ran at less than £500 million per year. In that year annual revenue increased to £1.1 billion with the sale of additional blocks of shares in BP and Cable and Wireless. Then in 1984–85, the first instalment of payments from British Telecom shares helped increase the 'take' to £2.1 billion, with additional payments raising the figure to £2.6 billion in 1985–86. From here on in, however, privatisation takes an increasingly dramatic turn. Projections for the proceeds for the three years to 1988–89, largely premised on the expected sale of the British Gas Corporation (and to a lesser extent British Airways) are for £4.75 billion per year, or around 2.5 to 3 per cent of total government outlays.

Considerable attention is now being paid to the question of whether the UK government has come to regard privatisation as a useful means of avoiding difficult budgetary decisions. This is also of some relevance for Australia's current crop of finance ministers and shadow treasurers, who may see in privatisation the opportunity to deliver tax cuts being called for by significant sections of the community.

In the UK, the all-important (to the Conservative government) Public Sector Borrowing Requirement (PSBR) is the focus of

macroeconomic policy, as expressed in the Medium Term Financial Strategy. The peculiarities of UK government accounting mean that the proceeds of assets sales are treated in the public accounts as a negative expenditure in the year in which the sale takes place (as are indeed the capital/borrowing requirements of the institutions thus removed from the public sector). This means that assets sales have a direct effect on the PSBR. The extent to which privatisations are being used as a means of hitting the PSBR target that would have been set in their absence, as against causing the government to lower that target, is not totally clear.

While it remains true that the peculiar accounting conventions of the PSBR give artificial incentives to privatisation, it does not appear that financial objectives have been the primary purposes, or achievements, of privatisation. (Kay and Thompson, 1986:29)

This confusion probably relates to another, slightly conflicting, criticism levelled at the government in this area of budgetary consequences. While some argue that privatisations are being used to finance current public expenditures, others claim that the government has sold off most of these industries too cheaply.

Asset sales result in a short-term reduction in the PSBR. But this gives a misleading picture of their effect upon public finances. When allowance is made for the effect upon future incomes and expenditures, the impact of asset sales is more likely to be neutral (if issues are priced appropriately) or adverse (if the issues are underpriced). In practice a number of issues appear to have been significantly underpriced. (Institute for Fiscal Studies, 1986:33)

This type of criticism stems from the observation that the government ought to be able to get no more from the sale of its public enterprise than the capitalised flow of net revenues (dividend payments plus capital gains) that the private sector purchasers expect to receive. If the enterprise is (roughly) equally profitable before and after sale, the government can do no more than break even.

As an example, Mayer and Meadowcroft (1985) estimate that the net worth of the public sector was lowered by £3.34 billion as a result of the sale of British Telecom. This figure is based on the difference between the market valuation of BT shares and the price the government received for them. The doubt I would raise, however, is over the prospect of British Telecom being worth anything like this amount to its owners had it remained forever within the public sector.

If one looks to the actual dividend performance of the publicly-owned British Telecommunications Corporation, the record is not good. While the organisation made substantial 'profits', in the sense of surpluses of current revenues over current expenses, these were inevitably reinvested in the business. In fact there was no such thing as a dividend (or tax) since, as noted in the BT accounts, 'the Corporation was not financed by share capital'. One finds in the accounts only new loans and repayments of loans. If it is assumed that the Treasury did not force the Corporation to pay above market rates for these borrowings, then the government in fact gained nothing, in financial terms, from its continuing 'ownership' of BT.

A similar observation seems to hold good for Australia. Of the major Commonwealth trading enterprises, only Qantas (a dividend of \$20 million), OTC (\$50 million) and the Commonwealth Bank (\$23 million) succeeded in returning dividends in 1985-86. Other entities, such as Telecom and Australia Post, are in any case not required to do so, while others, such as Australian Airlines and ANL, are usually unable to afford one. Over all, the dividend haul looks quite paltry against the combined turnovers, in excess of \$10 billion, of these institutions.

Of course, it might be argued that the prospect of one day having a 'jumbo sale' of state-owned enterprises does mean that these organisations are worth something to the government, even if they return no dividends at present. After all, this is how many gains are realised in private share markets. In fact it does not matter very much which view one takes. What is important is that the process of privatisation can involve a substantial one-off boost to revenue and it is up to the government to decide what to do with it.

Indeed, if it is the case that the government could have raised more revenue from a particular sale, the argument that it in fact ought to have done so stems not so much from the desirability of having that figure recorded in public sector accounts, but from the redistributive consequences of underpricing the issue. In fact, it is here that the Thatcher Government would appear to be quite cognisant of the results of its actions in underpricing its share issues. This tool has been used to keep the workforce on side, by offering larger and more heavily discounted share bundles to employees of the industry in question. It has also been used to spread the message of 'popular capitalism', by placing blocks of undervalued shares in the hands of enormous numbers of the population.

Of course, the gains in terms of 'popular capitalism' do not accrue quite as government rhetoric would suggest. There is little to prevent concentration of share ownership from taking place after sale, no matter how widely dispersed the initial holdings of shares. (Nor is this necessarily a bad thing, if one is to believe the literature on the

monitoring and control of private corporations.) This form of capitalism is, however, distinctly 'popular' since the recipients of the shares make money. The net result of this small lump-sum 'tax cut' is probably to achieve some minor redistribution in favour of potential Tory, as against Labour, voters, and to make a future policy of re-nationalisation (or 'de-privatisation', or increased 'social ownership') politically infeasible.

Depending on one's view of the distributional consequences, an alternative method of privatisation would in fact be to give the lot away. In my view, the major attraction of this path is that it would totally break the nexus between the other pro-competitive elements of the privatisation package and the government's revenue position.

## VI. THE PRIVATISATION PACKAGE

It has been argued that privatisation should be considered not merely in terms of the sale of publicly-owned firms, but as constituting a range of capital and product market liberalisations, tailored to the circumstances of the industry in question and aimed at maximising the benefits for consumers both directly and indirectly. The original Ridley report in fact stressed the competitive aspects far more than it did the actual sale of nationalised industries. It is in its departure from these principles that the Thatcher Government is to be most criticised.

One possible reason for this departure, which was suggested at the end of the last section, is the simple fact that monopolies are worth more to their owners than are competitive firms. It is by no means clear, however, that this has been the major obstacle to industry restructuring.

The clear theme to emerge from the political history of privatisation is that by far the most effective and influential of interest groups is the senior management of the potentially privatised industry. Their positive interest in privatisation is in being rid of what is seen as a burdensome form of Treasury control; their concurrent interests are in ensuring that this is achieved without change to the existing organisational structure and without a move to a more competitive environment. This is the structure they have supported in every case and, with one area of exception, it is a structure they have succeeded in persuading the government to adopt. (Kay and Thompson, 1986:29)

The one exception referred to is that of bus services, where the privatisation of the National Bus Company, expected to follow on from the 1980 deregulation of express coaching, has not yet occurred,

principally because the 'unit' of privatisation cannot be agreed upon. In other cases, though, the die has been cast. Indeed the prospect of being privatised intact seems to be serving as a positive lure for some of the potential privatisation candidates. To quote one such example:

Sir Walter Marshall, chairman of the Central Electricity Generating Board, said last night that he saw the privatisation of the electricity industry as a logical consequence of the proposed sale of the gas industry ... It would also be the 'only logical thing to do' for the Government to sell off the CEBG intact rather than power station by power station. This is what had been done with British Telecom and what was being done with British Gas. (*Financial Times*, 19 June 1985).

The attractiveness of following policies that win the support of management serves as a reminder of the very considerable political difficulties involved with the restructuring of nationalised industries. Given that these organisations exist so that they may modify the workings of market forces that would otherwise be released, it is necessarily true that an attempt to introduce competition will have some distributional consequences.

Probably the two most important ways in which public sector production and restriction of product market competition modify free market outcomes relates to the benefits received by the workforce, and to the (differential) benefits received by various classes of consumer. Public ownership has consistently resulted in manning levels and work practices that would not be tolerated in the private sector, and the lack of competitors has permitted cross-subsidisation of some consumers through the overcharging of others.

For the economist both effects amount to an inefficient use of the economy's resources. The problem as perceived politically, however, seems to depend very much on the extent of consumer, as against worker, benefits. In essence, there is likely to be far less enthusiasm for taking on an organisation that is redistributing between consumers, but managing to balance its budget overall, than there is one that is becoming a financial burden for government.

This distinction should be borne in mind when considering the privatisation experience in the UK. British experience with nationalised industry over the last two decades has been dominated by various attempts to improve financial performance. The problem industries of coal, steel and motor vehicles have, in the face of local and foreign competition and technological change, been placed under extreme pressure, yet their existence has been prolonged under public ownership. Successive governments have been faced with the choice between direct

revenue support, (further) elimination of competitors, or industrial confrontation.

In Australia on the other hand, these problems, though they have their private sector counterparts, fall outside the nationalised industry debate. Australia's portfolio of state enterprises does not include nearly so many 'lemons'. It is really only the various railways that present problems in terms of current subsidy levels, and even there the existence of substantial freight revenues in many parts of that industry makes its prospects brighter. Australia's conventional state enterprises tend to have a rather limited effect, negative or positive, on government revenues, with a resulting temptation on the part of their masters to let them continue to operate as they have done in the past.

And yet probably there is more to be gained for Australia in attempting some restructuring of our utilities, particularly in the fields of transport and communications. Australia's sheer size serves to emphasise the benefits to be obtained from increasing efficiency and innovation in these industries. The incumbents, however, have consistently claimed that considerations of geography dictate against entry into their markets. To my mind, though, they have not been able to substantiate this claim in terms of any undesirable tendency towards 'destructive competition'. Instead the argument has consistently ended up settling on the distributive impact on consumers, suppliers, workers, etc., at which point the political will for change has evaporated.

Given these facts of Australian political life, and the obvious hurdles to be overcome in attempting to privatise, we are faced with the decision as to whether future Australian governments should be content to sell off these industries as they stand, or whether they should reserve a portion of their political energies for battling the incumbents over issues of competition and industry restructuring.

There are essentially two views. One is that the mere conversion of public into private monopolies is not good enough. Until real competition is in prospect, whether between private and public sector bodies or totally within the public sector, the issue of changing the ownership structure should be left to one side as something of secondary importance. The alternative view would recognise that the sale of nationalised industries in the UK has been carried on against the background of some competitive initiatives, even if these have fallen far short of what might have been achieved. This, combined with the very fact that these industries are now not so 'special', in the sense that they are no longer in the public sector, may have opened the way for further gains.

Some moves to promote competition are better than none at all. The debate on whether the newly privatised enterprises are abusing their market power would hardly have taken off in an

earlier period when it was taken for granted that these were boring public utilities, reserved for state monopoly. (Brittan, 1986:38)

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# **Privatisation: Possibilities and Prospects in the Transport Sector**

*Keith Trace*

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# Privatisation: Possibilities and Prospects in the Transport Sector

*Keith Trace*

## I. INTRODUCTION

My paper explores the possibility of privatisation in various Australian transport markets. I have been asked by the organisers to concentrate on privatisation rather than deregulation. While I have attempted to follow their injunction, it has proved impossible — for reasons that will become clear during the course of this paper — to ignore completely the issue of deregulation.

What do I mean by 'privatisation'? The term has been used in a variety of ways. Four interpretations stand out: the transfer of responsibility in the welfare area from the state to the individual; the transfer of ownership of productive resources from the public to the private sector (i.e. denationalisation or the sale of public assets); deregulation (i.e. the removal of impediments to competition); and contracting out (i.e. the production of goods or services formerly the responsibility of the public sector by private firms). This paper is primarily concerned with the possible transfer of productive resources to the private sector. Issues relating to deregulation and contracting out are also raised.

The transfer of productive assets from the public to the private sector may take place in a number of ways. These include: full-scale stock market flotation of public enterprises; partial sale to the public; sale to employees; and the sale of sections of public enterprise that are separable from the core activity (e.g. certain railway lines, vessels employed in defined trades). Examples of actual asset transfers include the (UK) National Freight Corporation. This relatively small publicly-owned transport enterprise, whose assets include railway and road haulage equipment, was sold to its employees in 1981-82. The method of privatisation contrasts with that adopted in the case of British Aerospace,

a manufacturer of aircraft, guided missiles and space satellites. Here strategic considerations led the Thatcher Government to retain a 51 per cent share while the remaining equity was sold to the public. British Airways has been privatised, with preferential treatment given to employees wishing to buy shares and a minority of shares allocated to overseas investors.

In considering issues relating to privatisation we are fortunate to be able to draw on a burgeoning theoretical literature. We are able also to contrast the policy recommendations of this literature with the form of privatisation actually adopted (it is as yet too early to contrast the efficiency of the former public enterprise caterpillars with the newly emerged privatised butterflies). In the UK, the list of transport-related enterprises that have already been privatised (or that are intended to be privatised in the immediate future) includes: British Aerospace, British Airports Authority, British Airways, British Shipbuilders (part), British Leyland (part), British Ports, Sealink (Cross-Channel ferries), the National Freight Company, and the National Bus Company. We should also note that privatisation policies have been introduced in a number of countries including France, West Germany, the US, Canada, Malaysia, Singapore, Thailand and Japan.<sup>1</sup>

## II. WHY PRIVATISE?

### The Economic Case for Privatisation

Why privatise? The economic case for privatisation is based on the hypothesis that private firms are likely to be more efficient than public enterprises. Economic efficiency requires both productive efficiency (i.e. minimisation of costs of production for any given quantity and quality of product or service) and allocative efficiency (i.e. products or services of the desired quality provided at an acceptable price and in the quantities demanded). Privatisation, it is argued, should increase **productive efficiency**. In the absence of regulation, a privately-owned firm

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<sup>1</sup>The new French government is committed to denationalise banks and finance houses, insurance companies, and the five major industrial groups nationalised in 1982. The West German government is also committed to a privatisation program. Italian government holdings in some large companies (including Alitalia) have been sold. Plans have been announced for the partial sale of Aeritalia, an aerospace manufacturer. The Canadian government has privatised several large enterprises. The Japanese government is to privatise Japan Air Lines, Japan National Railways, Nippon Telephone and Telegraph, and Japan Tobacco.

pursuing profit-maximising policies has a direct incentive to minimise its costs.

Efficiency gains from privatisation arise out of capital market as well as product market pressures. Competition in product markets means that persistent underperformance will lead to bankruptcy. Competitive capital markets mean that a firm whose management is unable to reverse an incipient decline in sales and profitability will be liable to takeover. Competition in product markets has been seen as the mechanism through which inefficiency is revealed and the capital market as the mechanism through which efficiency may be restored (Domberger and Piggott, 1986).

Under public ownership the pressures giving rise to productive efficiency are muted. Public enterprises are not subject to takeover, so financial markets cannot act as an effective discipline. Governments may exert political pressure on the public enterprise, leaning on it to follow policies that may (or may not) be compatible with long-run economic health.<sup>2</sup> Incentive structures are flawed.

Whereas the management literature suggests that managers perform best when they are set a few specific goals against which their performance is monitored, public enterprise managers historically have not been set clear-cut profit objectives. Rather, they have often been set a number of sometimes conflicting objectives, among which cost minimisation has been assigned a low priority. The incentives offered to public sector managers have not been compatible with productive efficiency since typically neither financial reward nor career advancement have been linked to performance measures such as profitability or cost minimisation. The dilemma that arises has been highlighted by Brittan (1984:115): 'Even if Whitehall can persuade a nationalised industry chairman to price according to marginal cost, what incentive do his executives have to make these costs as low as possible, when the cost savings would not accrue to those making them and the threat of bankruptcy does not arise from failing to try hard enough?' The upshot, it is argued, is that public enterprises frequently employ excessive capital and labour. Excessive expenditure on labour may arise either through overmanning or through the granting of generous fringe benefits over

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<sup>2</sup>The Australian transport sector provides a good example. The Whitlam Government viewed ANL as a 'pacesetter', leading a revival of Australian flag shipping. In 1973 the government is said to have persuaded ANL management that it should become involved with the carriage of iron ore exports. Four large bulk carriers were ordered (at inflated prices). The losses of the four 'P' class bulkers were to be an important element in ANL's relatively large losses of the late 1970s and early 1980s.

and above the competitive wage (Domberger and Piggott, 1986). Thus while public enterprise may achieve productive efficiency, there is no overriding incentive to ensure this outcome (Forsyth, 1984).

We should note that privatisation will not necessarily increase **allocative efficiency**. When a private firm operates in an uncompetitive environment, it has a positive incentive to depart from allocative efficiency through the use of monopoly pricing. In contrast, the public enterprise has no incentive either to pursue allocative efficiency, or to avoid it (Forsyth, 1984).

The literature thus suggests that competitive, privately-owned firms have an incentive to achieve both productive and allocative efficiency (see Table 1). As Kay and Thompson (1986) note, privatisation tends to promote **productive efficiency**, the incentive to do so arising from the necessity for the privately-owned firm to achieve profits if it is to stay in business and avert the threat of takeover. In turn, competition promotes **allocative efficiency** since customer needs must be met if a firm is to survive in competitive markets. If, however, there is little competition in a product market, and if the risk of bankruptcy and takeover are slight, the pressures of the market 'may affect a private sector manager no more than his public sector counterpart' (Kay and Thompson, 1986:22).

Clearly, if economic efficiency is a primary goal, privatisation should be accompanied by an injection of competition in the case of hitherto non-competitive or imperfectly competitive markets. Artificial restraints on competition should be removed and policies of deregulation pursued. The relaxation of UK licensing requirements for long-distance bus and coach operators, encouraging the development of innovative new services, is a case in point. So too is the UK Civil Aviation Act of 1980, which required the Civil Aviation Authority to have regard to the benefits of competition when allocating routes. Decisions under this Act led to competition between British Airways and British Midland Airways on London-Glasgow and London-Edinburgh routes. This competition is said to have improved service standards (Brittan, 1984). In the absence of such competition, regulation must be used to limit the power of monopoly. The limitations of regulation, including the possibility that the regulatory body will be 'captured' by the regulated, have been well documented.

### **Empirical Studies**

Is the hypothesis that private firms are likely to be more efficient than public enterprises supported by empirical evidence? Pryke's study of the

Table 1  
**Ownership, Competition and Incentives to Efficiency**

	Publicly-Owned Monopoly	Publicly-Owned Competitor	Private Monopoly	Competitive Private Firm
Is the product market competitive?	No	Yes	No	Yes
Can the firm go bankrupt?	No	No	Yes	Yes
Can it be taken over?	No	No	Yes	Yes
Incentives to: productive efficiency	No	No	Yes	Yes
allocative efficiency	No	Yes	No	Yes

Source: Based on Kay and Thompson, 1986.

relative efficiency of public and private enterprises in the UK is the most comprehensive to date (Pryke, 1982). Direct comparison of performance was possible in three industries: airlines, ferries and hovercraft, and the sale of gas and electrical appliances. In each case, Pryke finds a more profitable private firm (or firms) increasing its market share at the expense of public enterprise. Comparisons of efficiency and cost levels typically favoured the private firm. Pryke concludes that the public enterprises studied were badly managed. His explanation for their poor performance hinges on a weak set of incentives resulting from public ownership (Kay and Thompson, 1986).

These conclusions have not gone unchallenged. Kay and Thompson (1986) argue that Pryke fails to distinguish effects on performance of ownership from those of prevailing market conditions. In their view, inefficiency may stem from an uncompetitive environment as well as from the structure of ownership. While it appears that British Airways 'is not an efficient airline either by the standards of other United Kingdom based operators or relative to other national flag carriers' (p.22), it does not follow that public ownership is the cause of BA's poor performance. Instead, the authors link BA performance to the highly regulated markets the airline serves. They further argue that the

publicly-owned Air Canada has been shown to be among the most efficient airlines. While Air Canada operates in the competitive North American airline market, BA operates for the most part on regulated routes (Kay and Thompson, 1986). Kay and Thompson conclude that 'it does not seem that there is anything intrinsically superior about performance under private ownership. There are efficient and inefficient public enterprises, and efficient and inefficient private enterprises'. However, they note that if capital markets are effective, unsuccessful private firms will tend to withdraw, 'thus market disciplines do more to improve the performance of the private sector than the public' (pp.23-24).

The evidence of superior private sector performance cited above stems largely from competitive markets. Does it hold when market discipline is blunted? Kay and Thompson (1986) review evidence from regulated industries and/or cases of natural monopoly, comparing performance between the privately-owned Canadian Pacific and the publicly-owned Canadian National, and between the privately-owned British Caledonian and the publicly-owned British Airways in regulated airline markets. They conclude that while 'no simple generalisation about superiority of private sector performance can be sustained ... there is support for the view that the efficiency of all firms — public and private — is improved by a competitive environment' (Kay and Thompson, 1986:25). However, Domberger and Piggott (1986) point to the inconclusive nature of the empirical literature. While Boercherding et al. (1982), citing more than 50 studies from five countries, report that the findings of most are consistent with the hypothesis that public firms will have higher unit cost structures, Milward (1982) finds no broad support for private enterprise superiority in the North American literature. Domberger and Piggott stress that their reading of the literature accords with that of Boercherding rather than Milward, and argue that the literature provides tentative support for the Kay and Thompson hypothesis that at least in some cases liberalisation without ownership transfer will improve productive efficiency (Domberger and Piggott, 1986).

### **Conflicting Objectives**

Recent studies stress potentially serious conflicts between the varying objectives of the British privatisation program, especially between financial objectives and economic efficiency. The literature suggests pitfalls that need to be avoided should Australia opt for a program of privatisation. The British government, it has been argued, views privatisation as serving a multiplicity of objectives (Kay and Thompson, 1986). One purpose is to improve the economic performance and economic efficiency of the industries concerned. Another is to resolve

problems of management and control that have bedevilled the nationalised industries. For its part, the Treasury is interested in the revenue accruing from the sale of public assets. Finally, the Thatcher Government has sought to encourage the emergence of a 'people's capitalism' through wider share ownership. The potential for conflict is evident. The value of the public assets is greatest if the privatised firm retains its monopolistic privileges, including restrictions on entry. But if it does, allocative efficiency will suffer since the private monopoly will be able to exploit its position by setting prices above marginal cost (Domberger and Piggott, 1986). The danger of adopting multiple objectives is that in the end no objective is efficiently attained, and in particular that 'economic efficiency — which is at once the most important of these and the most difficult to attain — has systematically been subordinated to other goals' (Kay and Thompson, 1986:19).

Such studies emphasise also the important role of pressure groups in determining the form of privatisation adopted. Kay and Thompson (1986) view senior management of the potentially privatised industry as 'the most effective and influential' of such interest groups. Their positive interest in privatisation, it is argued, is in ridding themselves of 'burdensome' Treasury control. But they are interested in achieving this without disturbing existing management structures and without a move to a more competitive environment. The authors stress that management's views have prevailed in several cases. For example, while the UK Civil Aviation Authority recommended that the privatisation of BA should be preceded by the building up of British Caledonian's route network, with the aim of enabling that airline to be an effective competitor, BA persuaded the government to reject this approach. British Caledonian was, instead, granted exclusive rights to certain lucrative (= non-competitive) routes to Gulf States.

Kay and Thompson conclude that the privatisation in the UK has increasingly come to emphasise the virtues of denationalisation over, and even at the expense of, the virtues of competition. This change of direction, they argue, is not supported by empirical evidence of the relative performance of public and private enterprise, which stresses the role of competition and supports scepticism about the value of privatisation outside a competitive environment (Kay and Thompson, 1986).

### III. PRIVATISATION AND AUSTRALIAN TRANSPORT

#### **An Historical Digression**

From the economist's perspective, the case for public ownership has rested on considerations of welfare or allocative efficiency. The

underlying assumption is that in a market economy competitive forces will generate an efficient pattern of resource use. It is of course recognised that there will inevitably be cases in which markets 'fail'. The most important causes of market failure are natural monopoly (i.e. where there are increasing returns to scale in production) and the presence of 'externalities' (i.e. cases in which costs or benefits are not reflected in market prices). Two types of response to market failure are of interest. In Europe governments have commonly responded by public ownership, whereas in the US natural monopolies have usually been subject to regulation.

Australia is characterised by a relatively large public sector. Was its growth a response to market failure? Colonial governments followed a policy of 'colonial socialism' in the second half of the 19th century, including large-scale programs of publicly-assisted migration and overseas borrowing to fund a public sector investment program. Development of transport and communication formed an important part of this investment program. However, the hypothesis that such developments were prompted by market failure has been rejected by Butlin (1983). In Butlin's view, public action **supplemented** rather than **displaced** private decision making in leading sectors of the economy. Business interests sought to limit their capital commitments by distributing widely, through public intervention, the costs of borrowing, of infrastructure and of immigration. Butlin notes that business paid a price for this in the creation of a powerful bureaucracy, and in private sector dependence on competing colonial governments. The picture that emerges is not one of market failure, or of crowding-out of the private sector by the public, but rather one of a partnership between the public and private sectors.

The post-1945 extension of public ownership, however, does appear to have been influenced by market failure, or at least by fears of such failure. While the founding of TAA owes much to the Labor Party's commitment to public enterprise, it also stemmed from fears of a private enterprise monopoly.<sup>3</sup> Similarly, the Two-Airline Policy, which

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<sup>3</sup> Brodgen (1968) notes that until 1945 the Department of Civil Aviation's policy was to grant only one operating license on any route. Competition was not permitted. The policy had been adopted during the 1930s, when civil aviation operators were subsidised. The attitude carried over to the debate regarding post-war civil aviation. The issue, as seen in 1944-45, was whether there should be a government monopoly or a private enterprise monopoly. Labor opted for a government monopoly, only to be stymied by a 1946 High Court decision that upheld the freedom of persons to engage in interstate trade under Section 92.

emerged after the election of Menzies in 1949, was the creation of a government seeking a competitive rather than a monopolistic (be it private or public) solution. A two-airline industry was the pragmatic response to the dilemma of creating competition in a 'thin' market.

ANL dates from 1956. Its background is that of a coastal shipping industry that had proved uncompetitive and unprofitable. Faced with intense competition from road and rail, and saddled with high costs dating from the old monopoly days (pre-1920), shipowners reacted defensively, aiming to minimise losses rather than create fresh opportunities. Unwilling or unable to find funds for fleet replacement, owners operated ageing fleets. ANL, formed to take over the assets of the loss-making Australian Shipping Board, and given the go-ahead to act commercially, might thus be seen as a response to market failure.

### **Ownership Structures and Competition in Australian Transport Markets**

Table 2 suggests that government instrumentalities play a major role in the provision of transport services. It also suggests that Australian transport markets vary in competitiveness and in the extent to which they are currently (or potentially) contestable.

With the exception of privately-owned WA mineral lines and Queensland cane tramway systems, rail services are provided exclusively by Commonwealth and State governments. During the 1960s, when the Pilbara iron ore lines were built, WA was unable to fund their construction. The State therefore required the mining companies to provide their own infrastructure, including railways, port facilities, roads and schools. State governments also provide fixed-rail urban passenger transport and are responsible for a high proportion of urban bus transport. Private operators also provide bus services under license. Competition along a given route is rare.

In contrast, government operates few country or interstate road transport services. Minor exceptions include freight and passenger transport linked with the State rail networks. While important to some rural communities, these are of little significance when compared to the totality of road freight and passenger transport movements. Interstate freight and passenger markets were effectively freed from economic regulation as a result of the 1954 Hughes and Vale decisions. Considerable progress has been made in the 1970s and 1980s in freeing intrastate transport markets.

Intrastate and domestic aviation markets are subject to economic regulation. The publicly-owned Qantas is the sole Australian carrier permitted access to international markets, although we should note

Table 2  
Ownership and Competition in Australian Transport Markets

Market	Public Ownership	Private Ownership	Degree of Competition	Is Market Currently (Potentially) Contestable?
<i>Road Transport</i> freight	No (minor exceptions)	Many operators	High	Yes
passenger - long distance coach	No (minor exceptions)	Several operators	High	Yes
<i>Rail</i>	ANR (C'wealth), NSW SRA, VicRail, etc. etc.	Mineral lines (WA) and sugar cane tramways (Q)	Road-rail	No
<i>Urban Transport</i> rail	NSW Met rail, Vic MTA (rail)	No	Low	No
bus	NSW UTA, Vic MTA etc.	Many (licenced) operators	Low	No (Yes)
<i>International Aviation</i>	Qantas	No	Moderate	No (Yes)
<i>Domestic Aviation</i> trunk routes	Australian Airlines	Ansett	Low	No (Yes)

regional routes	No (minor exception - Australian Airlines)	Several operators	Low	No (Yes)
commuter routes	No	Many operators	Low/Moderate	* (Yes)
air freight	Australian	Ansett, IPEC, etc.	Moderate	Yes
Airports	Cwealth Gov, Local (municipal)	Limited	Low	No
Shipping				
coastal shipping	ANL, WA Stateships, Tas. Transport Comm.	Several operators	Low	No (Yes)
overseas shipping	ANL	Many operators	High	Yes (**)
Ports	NSW MSB, Port of Melbourne, etc.	Some private mineral ports (WA)	Low	No

Notes: \*Varies across States. Note that South Australia has deregulated its internal air routes, and WA has partially deregulated.  
 \*\*The conference system potentially inhibits contestability of liner shipping.

Ansett's links with Pacific island nations (vide the 767 service to Rarotonga). The government-owned Australian Airlines competes with Ansett on domestic trunk routes. Under the Two-Airline Policy services between designated trunk ports are (almost exclusively) reserved for these two carriers. The one chink is the opening for regional operators whose 'prescribed' routes happen to indirectly link trunk ports. We should also note that air freight has been deregulated. Regional and commuter services are in general provided by the private sector. Economic regulation of regional and commuter aviation varies between States. South Australia has recently deregulated its intrastate airline market, while WA has introduced competition on some routes.

Of the 440 government or licensed airports open to civil aviation in 1985, 69 were Commonwealth-owned, 270 were operated by local authorities under a local ownership program, and the remainder were either privately or municipally owned (Department of Aviation, 1985). It is government policy to transfer a further 40+ airports to local ownership. Responsibility for the (17) remaining major Commonwealth-owned airports has been transferred to a new Federal Airports Corporation. We should note that a wide range of airport services is already provided by the private sector.

Government enterprises play a major role in coastal shipping. ANL has a relatively large coastal fleet, providing roll-on roll-off services across Bass Strait and along the east coast. ANL also operates in the coastal bulk trades. The Tasmanian Transport Commission operates the passenger-car ferry *Abel Tasman* and several cargo vessels in Bass Strait. WA Stateships operates liner services to the state's northwest and Darwin, as well as an east-west service linking WA with Tasmania and Victoria. Coastal trades are also served by private sector operators and by fleets operated as part of a vertically integrated sequence of operations (e.g. BHP). Competition is limited as a result of the provisions of the Navigation Act. De facto, if not de jure, Australia has adopted a cabotage policy.

ANL also operates in the overseas liner and bulk trades, competing with other national lines and with private sector shipowners. In general, competition is keen, although we should note that liner trades are cartelised. The power of shipping conferences is, however, limited during periods of over-tonnaging, and such is certainly the case at the moment.

The provision of port facilities is of State rather than Commonwealth concern. While some States (NSW, Queensland) have historically favoured centralised control of ports, others (Victoria, WA) have favoured autonomous local control. There are few private ports. The private ownership of port facilities is confined to some iron ore ports in WA, although more recently there has been a tendency to grant the users of special berths greater commercial freedom (vide Westernport,

Table 3  
Ownership and Administration of Australian Ports

Type	Advantages and Disadvantages	Examples
Autonomous Public Trust	Unified functional administration over defined area. Possible insufficiency of funds and lobbying power in its own cause. National port policy impossible unless some surrender of authority.	Port of Melbourne Authority Port of Geelong Authority Port of Brisbane Authority Port of Hedland Port Authority Fremantle Port Authority
Central Government Authority	National port policy possible. Disadvantages include political influence over decision making, absentee direction.	No Australian authority. Overseas examples include Argentina, Italy (excl. Genoa, Trieste) and, until recently, UK.
Other Public (State or Municipal)	Local administration, adapted to needs of each port. Disadvantages include local politics, port needs may outgrow local authority, port may be taxed to help city or state.	Queensland Department of Harbours and Marine (Hay Point, Lucinda, Weipa, etc.) Maritime Services Bd of NSW
Private	Operated as commercial enterprise, with flexible administration geared to maximising profits of port or port complex.	Dampier (WA) Cape Lambert (WA)

Source: Adapted from Bird (1971).

Victoria). The literature on port administration favours the autonomous public trust form (Table 3). Port services may be provided by the port authority, by other public bodies, or by private undertakings (Table 4). In general, towage, berthing/unberthing and ship repair are provided by the private sector, as are the majority of services related directly to cargo handling.

### **Public vs Private Sector Efficiency: The Australian Evidence**

There have been few studies of the relative efficiency of public and private sector enterprises operating within Australia.

The domestic airline industry has been the subject of a major research effort. Davies (1971) began the debate when he hypothesised that a private firm might be expected to be more efficient than a comparable public firm, even in a regulated industry, because the management and shareholders of the private firm were able to capture some of the benefits of greater efficiency. Davies's findings (Table 5) showed that Ansett was indeed more efficient than TAA. However, later studies have stressed the similarities rather than the differences between Ansett's and TAA's performance (Forsyth and Hocking, 1980). Regulation has been held responsible for cost inefficiencies of both public and private enterprises (Hocking, 1979, and others) (Table 5). A recent survey suggests that two tentative conclusions emerge from this literature. First, both airlines are much less efficient than 'similar' North American operations. Second, the private enterprise airline is somewhat more efficient than the publicly-owned airline (Domberger and Piggott, 1986).

A 1985 study by Travers Morgan, commissioned by the NSW Bus and Coach Association, suggests that private bus services can be operated for half the cost of government-operated services: The NSW Urban Transit Authority's buses were found to cost \$3.20 per km to operate, whereas the figure for private buses was only \$1.50 per km. These services are operated within a highly regulated environment.

While other studies of comparative efficiency appear feasible, none have been published. It would be interesting to compare the efficiency of mineral and/or coal haulage on the NSW and Queensland rail systems with that achieved by the privately-owned Pilbara lines. The difficulty here is that of disentangling the resources used for mineral/coal haulage on the State rail systems as well as obtaining access to confidential data from the mining companies. Similarly, it ought to be possible to compare the efficiency of ANL's coastal operations with that of private sector coastal operators. One suspects that coastal shipping might be another case in which regulation has had a detrimental effect on the efficiency of both public and private sector operators.

Table 4  
Providers of the Main Services in Ports

Main Port Services	Developed Countries				Developing Countries			
	Port Authority	Other Public Bodies	Private Undertaking	Total	Port Authority	Other Public Bodies	Private Undertaking	Total
<i>Services to Ships</i>								
Aid to navigation	10	13	0	23	36	17	0	53
Pilotage	10	8	5	23	36	7	12	55
Towage	6	1	13	20	35	4	16	55
Berthing/unberthing	4	0	17	21	31	3	18	52
Repairs	0	1	21	22	9	7	35	51
Marine police	7	13	0	20	13	33	0	46
Fire fighting	6	16	0	22	32	23	0	55
<i>Services to Cargo</i>								
Stevedoring	3	1	18	22	10	11	36	57
Cargo-handling on quay	4	2	18	24	27	10	19	56
Surveillance	6	5	12	23	20	13	21	54
Tallying	5	2	16	23	22	11	22	55
Weighing	7	5	11	23	28	9	16	53
Storage	8	3	12	23	34	10	12	56

Note: Not all ports provide all services, and some ambiguous answers have not been retained. This explains why the numbers in the 'Total' columns vary slightly.

Source: Compiled by the UNCTAD Secretariat (1975).

Table 5  
**Summary of Evidence on Comparative Economic Performance of Australia:  
 Two Major Domestic Airlines**

Study	Performance Measure	Finding	Remarks
Albon & Kirby (1983)	Index of cost efficiency	Public/Private both efficient.	Costs above minimum achievable levels. Regulation causes 'cost padding'. Lack of competition (market entry) causes cost inefficiencies.
Davies (1971, 1977)	Labour productivity measures	Private more efficient.	Private firm 12 to 100% more efficient. Public ownership inherently inefficient — 'property rights' approach.
Dept of Transport Domestic Air Transport Policy Review	Various measures	Public/Private may both be inefficient.	Insufficient information to make firm conclusions about absolute efficiency levels. May, however, be scope for improved efficiency. Recognises international comparisons not infallible.
Hocking (1977)	Physical units of inputs and outputs	Public/Private both inefficient. North American firms more labour productive.	Costs above minimum achievable levels. Regulation causes cost inefficiency.
Forsyth & Hocking (1980)	Labour productivity measures	No difference in Public/Private performance. US firms markedly more productive.	Regulation responsible for similar economic performance. Higher productivity in US associated with more flexible regulation and greater competition.

Holcroft Report	Various measures	Public/Private both inefficient.	Regulated environment 'second best'. Regulation causes cost inefficiencies.
Jordan (1981)	Not available	Similar Public/Private performance. North American firms more efficient.	Regulation constrains operators to similar economic performance. Ownership has little effect. Competition associated with more efficient US operations.
Kirby (1979)	Social welfare costs	Public/Private both inefficient.	Regulation of domestic air industry imposes welfare cost on community in the order of 50% of gross industry revenue.
Kirby (1984)	Index of cost efficiency	Private marginally more efficient. US firms markedly more efficient.	Public firms' operating costs 51% higher. Australian firms' operating costs 55% higher than equiv. US operations before deregulation.
Kirby & Albon (1985)	Index of cost efficiency	Private more efficient.	Difference in efficiency between public/private firms small in comparison to gross inefficiency in both resulting from regulation.
Mackay (1979)	Operating costs per tonne-km and other measures	Private marginally more efficient. North Amer. firms more productive and cost efficient.	Regulation forces costs above minimum achievable levels. Recognises international comparisons not infallible.
Milward and Parker (1982)	Productivity	No difference in productivity.	

Source: Domberger and Piggott, 1986:153.

### **Other Evidence Concerning the Efficiency of Public Sector Transport Undertakings**

While it is not possible in many cases to compare the relative efficiency of public and private enterprise, we do have considerable evidence regarding the level of efficiency of publicly-owned transport undertakings. Constraints of space and time dictate that the consideration of this evidence be brief.

The Commonwealth and State railway systems operate with substantial deficits, the State systems incurring a combined deficit in excess of \$1200m in 1983-84 (Commonwealth Grants Commission, 1985). These systems covered only 62 per cent of their working expenses and capital charges in that year.

Because of rail's labour intensiveness (labour accounts for 60 to 70 per cent of working expenses), labour productivity is central to financial performance (Australian Railway Research and Development Organisation [ARRDO], 1981). While labour productivity has improved, it has not risen sufficiently in relation to real wage increases to bring down deficit levels. Staff reduction has proved a real stumbling block to rail systems, reduction through attrition tending to lead to imbalances in skills.

The financial plight of the railway systems has been worsened by their failure to adjust their operations to demand. Some rail services (including passenger and a range of freight services) continue to be provided despite their failure to cover avoidable expenses (ARRDO, 1981). Cross-subsidisation clearly occurs. It is evident, for example, that the revenue from coal traffic cross-subsidises other traffics in Queensland, as well as enabling QR to show a surplus of \$100m+ in 1985-86.

ANL too is bedevilled by high labour costs and inefficient work practices. Crew levels on Australian container vessels engaged in overseas trade vary between 31 and 36, considerably above levels prevailing in Japan and the major European countries.<sup>4</sup> Moreover, officers and ratings accrue leave entitlement at the rate of .926 of a day for each day on articles, giving a leave entitlement of 338 days for each

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<sup>4</sup>We should note that the vessels concerned were built and crewed in the late 1960s and 1970s. Had ANL commissioned new container vessels between 1983 and 1986 crew size would probably have been 26 ( $\pm 1$ ), a level still high by international standards. The October 1986 report of the Maritime Industry Development Committee has based its manpower plans for the industry on a crew of 21 in the next generation of Australian flag vessels.

year served on articles, very generous by international standards. As a result Australian shipowners must operate a full two-crew system. Australian award wages (and on-costs) are high by international standards. Crew accommodation standards are also high. It would appear that Australian crews perform less on-board maintenance than the crews of some overseas countries. We should note, however, that these wage levels and conditions are not simply the product of public ownership. The conditions are common across the industry, and undoubtedly evolved as a result of the lack of competitive pressure in a coastal shipping industry sheltered by the Navigation Acts.

The low level of productivity in container terminals is also of concern. The rate of container handling is well below that achieved in major European, Japanese and Southeast Asian ports. Stevedoring gangs are relatively large and work practices appear inefficient. As a result the cost of handling containers in Australian ports is high by world standards. Here too the problem is an industry one. ANL's terminal problems are not unique. Prices Justification Tribunal inquiries have linked low productivity to a lack of competition. Container terminals are commonly owned by shipping companies and it is frequently alleged that shipowners are more concerned to avoid delays to their vessels than they are to minimise the cost of terminal operations.

#### **Priorities: Supply and Demand Prospects**

Beesley and Littlechild (1983) provide a convenient methodology for assessing the potential of and priorities for privatisation. The authors argue that priority should be given to industries whose privatisation promises the greatest net benefit to consumers, this criterion being chosen in preference to the more complex procedure of estimating the effect of privatisation on the various interest groups involved (existing and potential consumers, taxpayers, management, employees, shareholders, etc.) and devising appropriate trade-offs. As Trengove has noted elsewhere in this volume, benefits to consumers arise if privatisation leads to more efficient operation and increased innovation. Benefits may then accrue directly (i.e. through lower prices and/or improved quality) or indirectly (i.e. through lower taxes, made possible through reduced levels of subsidy).

Beesley and Littlechild argue that consumer benefits are likely to be maximised in the case of: (a) large industries, since other things being equal a larger industry offers greater scope for savings; (b) industries that are more competitive after privatisation; and (c) industries that have not been subject to 'remedial action' (i.e. rationalisation or cost-cutting measures), since these offer more scope for savings than those that have been.

Beesley and Littlechild classify candidates for privatisation in terms

of their 'supply' and 'demand' prospects. Demand prospects are classified as 'good' or 'bad' depending on long-run trends, and supply prospects classified as 'conductive to 'single' or 'multiple' (i.e. competitive) ownership depending on developments in technology.

Trengove's Table 1 (p. 189 in this volume) suggests that, ranked by turnover, the largest publicly-owned enterprises in the transport sector are, in descending order of importance: State Rail Authority of NSW, Qantas, Australian Airlines, ANL, Maritime Services Board of NSW, Urban Transit Authority of NSW, ANR, and VicRail.

My assessment of the 'supply' and 'demand' prospects for these (and other) enterprises, if privatised, is shown in Table 6. (Note the substantial agreement between Trengove and myself regarding these prospects.)

Table 6  
Post-Privatisation 'Supply' and 'Demand' Prospects  
for Australian Public Sector Transport Enterprises

		Demand Prospects	
		Good	Bad
Supply Prospects	Single	A. Federal Airports Corp.	B. ANR State rail systems (NSWSRA, VicRail, etc) Urban transport (rail) Ports (NSWMSB, Port of Melbourne, etc)
	Multiple	C. Qantas Aust Airlines TT-Line (Abel Tasman)	D. ANL WA Stateships Urban transport (NSWUTA, etc)

Beesley and Littlechild's third criterion, that other things being equal industries that have not been subject to 'remedial action' (i.e. rationalisation or cost-cutting measures) offer more scope for savings than those that have, poses more problems. Most of the enterprises listed in Table 6 have been the subject of some remedial action. A new Act and a change of management structure has made ANR more commercially oriented. ANL has just emerged from a traumatic reorganisation. Following the Line's losses in the late 1970s and early 1980s, and the injection of \$160m by the Commonwealth, ANL has

reduced its fleet, abandoned some trades and adopted new management techniques. The Maritime Services Board of NSW is currently undergoing reorganisation. The 'old' MSB was in many ways the archetypal public sector body, theoretically accountable to government but in practice possessing considerable autonomy. Accountability was weak, the authority was not responsive to its customers' needs, and its cost structure was very high (Hoy, 1986). The present Board of Directors is attempting to implement a thoroughgoing reorganisation, aiming to make the MSB more responsive to market demand and more cost-conscious. These and other examples raise some problems. Are there worthwhile gains in privatising a public sector body that has undergone thorough rationalisation? Are the reforms of MSB (or ANL, or ANR) likely to result in long-run improvements to the efficiency of those bodies, or will they return to their old ways in the course of time?

#### **IV. POSSIBILITIES, PROSPECTS, PITFALLS**

We have earlier argued that privatisation might be accomplished in a number of ways: (1) through the sale of assets; (2) through deregulation (with or without the sale of assets); (3) through franchising or contracting out. These mechanisms for privatisation differ in the extent to which they achieve desired policy objectives (Table 7).

The issue of **policy objectives** is crucial in the privatisation debate. The appropriate instruments or mechanisms of privatisation vary according to the policy goal(s). If, for example, the primary goal was the maximisation of revenue from the sale of public assets, it would be appropriate to retain existing regulation of the industry in question. The sale of a transport enterprise operating in a regulated environment (say, an airline) involves the sale of two separate (and separable) assets: the physical enterprise, including the aircraft, equipment and managerial expertise; and a set of rights to routes capable of yielding profit (Forsyth, 1984). If, on the other hand, the primary goal of privatisation is to improve the economic performance of the former public enterprise (i.e. economic efficiency), then simultaneous privatisation and deregulation (presuming the market is contestable) would appear appropriate. This approach should enhance both allocative and productive efficiency (Tables 1 and 7).

Let us assume (unless otherwise specified) that the primary goal is economic efficiency. For simplicity, we will discuss the potentialities of privatisation under two conditions: where markets are natural monopolies and/or non-contestable, and where markets are (at least potentially) contestable.

Table 7  
Objectives and Instruments of Privatisation

<i>Instruments</i>	<i>Objectives</i>				<i>Remarks</i>
	<i>Allocative Efficiency</i>	<i>Productive Efficiency</i>	<i>Revenue Receipts</i>		
1.1 Asset Sales	No	Yes	Yes		Regulatory framework required to control monopoly abuse
1.2 Asset Sales (of companies in competitive product markets)	Yes	Yes	Yes		
2.1. Deregulation (with asset sales)	Yes Provided market is competitive or contestable	Yes	Yes	Yes	But less than in 1.1 if incumbent's dominance is expected to be short-lived.

2.2 Deregulation (without asset sales)	Yes Provided market is competitive or contestable	Yes Provided trading losses are not under- written by the government	No	
3.1 Franchising (Chadwick-Demsetz Auction)	Yes Provided bidding is competitive	Yes Subject to contract being incentive-compatible	No	} Franchising authority required to monitor and enforce contracts
3.2 Franchising (Monopoly Rents Auction)	No	Yes	Yes	

Source: Domberger and Piggott, 1986:155.

### Natural Monopolies or Non-Contestable Markets

Several transport markets (railways, airports, ports) are generally considered to be natural monopolies. As Kay and Thompson have noted, natural monopoly is more obvious in those industries that involve distribution networks — local telephone services, gas and electricity distribution (but not production), railway systems. Airports and seaports are neither competitive nor contestable. The supply of good sites is limited. Sunk costs (pardon the pun) are high.

What options are open in such cases?

(i) The enterprises as a whole might be sold to the public. The outcome would depend in part on the entity actually chosen as the unit of sale. For example, suppose the decision were taken to privatise New South Wales's ports. The Maritime Services Board (which has a monopoly in the provision of ports) might be sold as a package. In this case the privatised firm would possess monopoly power over the provision of port services throughout NSW. To the extent that this monopoly power was exercised, allocative efficiency would suffer. Alternatively, individual ports might be privatised. Competition between the privatised ports of, say, Newcastle, Sydney and Port Kembla might be expected to restrain the exercise of monopoly power.

The financial position of the State railway systems (and some ports) is such that they are unlikely to be attractive to the private sector. Here I note the Japanese government's reform plans for the heavily loss-making Japan National Railways (JNR). Under the reform plan, JNR is to be divided into ten separate companies — six regional passenger companies, one national freight company, and companies relating to technology, telecommunication and reservations. The aim is to achieve profitability for each company prior to privatisation. The expectation is that the breaking-up of the monolithic JNR into separate profit centres will expedite commercial decision making, especially the hard decisions regarding the scale of operations and the size of labour force employed. JNR shares with our state rail systems a problem of accumulated debt. Presumably these debts should be substantially written off prior to privatisation.

(ii) An alternative approach is suggested by a closer examination of the 'natural monopoly' argument. What elements of, say VicRail, constitute a natural monopoly? The analogy with telecommunications would suggest that the track and signalling systems alone constitute a natural monopoly. If this is the case, the provision of locomotives, rolling stock and the operations of services might be amenable to competition. Even if a single supplier were desirable (say for reasons of timetable coordination) competitive bids to supply the service might still be called for. As Swan and Nestor (1983) note, the first steps have already been taken by the freight forwarding companies. TNT and other

freight forwarders provide a range of terminal facilities and equipment in connection with their overnight and intercapital freight trains.

Franchising or contracting out appear to offer considerable potential in the transport sector. Forsyth (1984) has argued that the operation of airports, including both aircraft services and terminal operations, might be put out to tender. Alternatively, private firms could be given a fixed price, dependent on throughput of aircraft and passengers. Given that the firm could retain profit, this should ensure productive efficiency (Forsyth, 1984). There are obvious analogies with seaports. In the UK, Hereford and Worcester have allocated bus services by the tender method. It is claimed that subsidy levels and/or fares have fallen, without a reduction in service quality (Brittan, 1984).

### **Markets That Are Potentially Contestable**

The policy prescription is more clear-cut and the decision easier where markets are contestable (or potentially contestable). Transport markets that are at least potentially contestable include domestic and international aviation, international and coastal shipping, inter- and intrastate road transport, and (possibly) urban bus transport. Here the privatised, deregulated firm should achieve both allocative and productive efficiency (Tables 2 and 7).

We should, however, beware of potential pitfalls. First, the widely debated issue of 'cream-skimming'. Cream-skimming may occur where public and private operators compete in a deregulated market. Private operators would naturally seek to operate in the more profitable segments, along the routes with the densest traffic. A public enterprise with a residual obligation to service unprofitable routes would be at a disadvantage in such a situation. The remedy lies in direct subsidisation of the socially desirable but economically unprofitable 'thin' routes.

Predatory action by a large operator to force a smaller rival to abandon a market is another potential pitfall, especially where the larger operator can use profits from regulated markets. Forsyth (1984) notes that BA would be in a position to use profits from its regulated routes to finance efforts in competitive markets. Similarly, the UK express coach market, deregulated by the 1980 Transport Act, is still dominated by National Express. It has been argued that National Express possesses one great advantage over its competitors: ownership of the centrally-located Victoria Coach Station in London (Domberger and Piggott, 1986). The effect has been to blunt the impact of the deregulation policy. The theory of contestable markets would suggest that legislation designed to allow competitors access to terminals would be appropriate in this case.

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# COMMENTS

*Peter Forsyth*

I find myself in agreement with virtually everything that's been said in these two comprehensive papers. I'd like to develop two of the issues that have been introduced: the measurement of the gains and losses arising from privatisation, and the practical problems involved in carrying out privatisation. These are the major unresolved areas in the privatisation debate.

First, the issue of measurement. Economists haven't done a great deal in the way of measuring the gains and losses that might possibly flow from privatisation. This is probably because there isn't much of a market in analysing public enterprises. Neither management nor workers welcome scrutiny of their activities; and the government, as the owner, is likely to be hostile as well. (There is, of course, a demand for scrutinising private firms, coming from shareholders and potential shareholders.) Keith Trace has summarised about as much as we know on the subject in Australia. Airlines, banks and urban buses have been examined; but we don't really know how well Telecom and the State rail authorities, for example, are performing. A number of public-private comparisons have been undertaken overseas, mainly in the USA. But these tend to compare public monopolies with private regulated monopolies. They find that there are good and bad performers in both groups. This is hardly surprising. We would expect regulation (especially the regulation of profits, as occurs frequently in the USA) to reduce the incentive to be efficient. What we really need to know is how well unregulated private monopolies perform.

There are two kinds of discipline tending to reduce the welfare losses arising from private unregulated monopolies. The first and more important is indirect competition. Railways have to compete with buses and trucks, for example. The second discipline is 'contestability', or the possibility of other firms entering the market and competing with the original monopoly. However, there is some emerging evidence that potential competition is a much weaker discipline than actual competition. Usually, the key assumptions of contestability are not met.

To summarise the case for privatisation: we are trying to balance possible allocative losses with productive gains. We need to estimate the strength of the monopoly power in each instance, and the likely

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monopoly welfare costs. In addition, we have to recognise that in public enterprise prices may not be, and usually are not, perfectly efficient. We can identify a number of allocative efficiency losses arising from the way public firms manage their prices. Ad hoc theory and some empirical studies suggest that this loss may, however, be relatively small, even if the private firm takes full advantage of its monopoly power. There are, of course, distributional questions. But we need to remember that when the government sells a firm, it can realise in the selling price the gain from the capitalised monopoly profits. Then there are the productive efficiency gains. Empirical analysis suggests that these gains may be quite large. Again, we have to remember that private firms may not be perfectly efficient in terms of productive efficiency. So in a number of cases, it could be that private unregulated monopolies are preferable to both public monopoly and private regulated monopoly. But this is a problem for analysis: we really need to measure just how big the gains and losses are.

Our second issue concerns the practical difficulties in carrying out privatisation policies. Inefficiency is present in public enterprises and in regulated private enterprises because various groups gain from it: management, workers, favoured consumers, and politicians. These groups will naturally resist attempts to remove inefficiency by policies of deregulation and privatisation. How can we deal with them? One option is to try to buy them off. An example of this is British Airways, whose efficiency has been greatly improved in preparation for privatisation. The labour force was reduced by the offer of generous redundancy payments from £35 000 to £55 000. But this approach can be dangerous, because it encourages interest groups to form themselves in order to benefit from the buying-off arrangements. A second option is to deregulate or privatise without compensation. But governments rarely dare to do this. Even Britain's Thatcher Government has backed down in a number of instances. For example, British Telecom was sold off in a far less competitive environment than it might have been, and is also virtually immune from the threat of takeover. These factors greatly reduce the incentives for competitive performance.

In summary, successful privatisation policies have to identify the groups that gain from present inefficiencies. If these groups' privileges are maintained, then privatisation may fail to produce the desired efficiency gains. Governments are therefore faced with two choices. Either they must be prepared to take some very tough decisions, and accept the consequences in terms of alienating various groups; or they must be able to devise schemes that satisfy two criteria: first, they are compatible with incentives for improved efficiency, and second, they attract the support of those who would otherwise lose. Working out such schemes is, to my mind, the most difficult aspect of the practice of privatisation.

## DISCUSSION

**Patrick Minford (University of Liverpool):** I'm rather puzzled by Peter Forsyth's emphasis on measuring the gains and the losses from privatisation and other kinds of intervention. In the long term, there are no trade-offs, because if privatisation does increase the efficiency of the economy, it increases the amount of revenue governments can raise from taxation. Surely we have learned from the Austrian School that we are dealing with a dynamic process, so that it's missing the point to measure static gains and losses. For example, Keith Trace cites Kay and Thompson's finding that public enterprises will perform well under competitive conditions. But the point is that competitive conditions are much more likely to be found in the private sector than in the public. What we need is a system that allows free entry and 'creative destruction', and that means taking government, the ultimate barrier, out of the process.

As for the short term, economists have done a disservice here by concentrating only on the efficiency aspect. Beesley and Littlechild's list of priorities for privatisation, which both Keith Trace and Chris Trengove cite, misses the political aspect of privatisation. The short-run objectives that enable privatisation to succeed are political — the prospects for raising revenue, for reducing subsidies, for encouraging popular capitalism, and so on. Britain's privatisation program has been successful only because it has been so well managed politically.

The link between privatisation and tax cuts has been much discussed in the UK. But suppose that Mexico were to sell its public assets in order to pay off its public debt. I think we would have a very different view of the Mexican economy. Of course, using the proceeds from privatisation as revenue is technically the same as borrowing. But practically it is not, because privatisation is part of a dynamic process of reducing the role of the state, improving economic efficiency, and enhancing the long-term prospects for tax cuts and a balanced budget.

**Keith Trace:** In citing Kay and Thompson and others, I was assuming that it wouldn't be possible in Australia to go all the way with privatisation, and I was interested in the likely efficiency effect of deregulation on public bodies. I take Professor Minford's point about the shortcomings of short-run, static comparisons. I have the impression that he regards the political aspect as so central that it takes precedence over economic logic; but no doubt he doesn't mean to give that impression.

**Peter Forsyth:** I agree with Professor Minford about the long-term dynamic gains from the process of 'creative destruction'. But the short-term static gains and losses can also be very substantial. I think he has missed the point about Kay and Thompson's analysis. Kay and Thompson point out that privatisation has been carried out in such a way as to limit competition in a number of cases. With British Telecom, British Airports Authority and British Airways, the opportunities for increasing competition were not taken; and the managements of these enterprises will naturally resist any attempt to deregulate them at some future date. This will reduce the dynamic gains as surely as it has the static ones.

**Wolfgang Kasper (University of New South Wales):** An important exception to the general rule that Australia has no publicly-owned manufacturing enterprises is the defence support industries. These industries are heavily subsidised, but the costs to the taxpayer and to defence preparedness are frequently overlooked. The experience of a drawn-out world war induced Australians to retain defence factories, but a future high-technology war would have to be fought from stock, and low-level contingencies would not disrupt supplies of cheaper, imported defence goods.

It is typical that the Australian defence industries have extremely powerful unions, which prejudice our defence preparedness and national sovereignty (remember the loading strikes during the Vietnam war). Cost efficiency is often shockingly low, but this is frequently disguised by the strategic need for overcapacity and by arguments for secrecy.

We need a critical review of which defence manufacturing activities must be retained for security or special-skill reasons, and which should be sold off. There are no grounds whatever for the retention of government-owned firms making clothing and footwear for the armed forces.

**Ray Evans (Western Mining Corporation):** My point arises from Chris Trengove's illuminating discussion of the influence of the senior management of the large public enterprises in the UK, who have used their influence to ensure that the enterprises are sold to the private sector intact. A primary objective of a privatisation program should be to break up these large bureaucratic structures, which are costly and generate correspondingly strong trade union structures. The influence of the existing management would be neutralised if the enterprises were broken up prior to privatisation into a number of independent and autonomous firms, thus creating a new class of managers with a vested interest in the decentralised system.

### *Restraining Leviathan*

**Chris Trengove:** Certainly, more consideration could be given to devoting some of the privatisation effort to prior restructuring. In the UK, one could compare the 1984 Telecom Privatisation Act with the earlier legislation that separated Telecom from the Post Office. The separation in 1975 between Telecom Australia and Australia Post has, in some areas at least, led to a much smaller bureaucracy, and enforced some competition between the two organisations. The efforts to have OTC included in Telecom were resisted; we also have a separate Aussat. I'm puzzled why the pure competition argument hasn't found a greater acceptance. In the UK, the British Airports Authority owns seven airports, despite a strong case for managing the airports separately.

**Robin O'Hair (University of Queensland):** The anarcho-syndicalists have taken an intermediate step towards privatisation by making harbour boards and other kinds of boards elective. That system tended to reduce the exploitation of consumers so long as the franchise wasn't unduly wide.

**Trace:** That's interesting in the light of the possibility of harbour boards being captured by shipping operators. The literature on this subject on balance prefers the elective harbour board to privatisation.

**Simon Oke (Liberal Party of Australia):** One way of disciplining the private unregulated monopoly is to create a healthy market for corporate control, that is, a healthy takeover market. This is especially useful where the monopoly is a natural one and there is no possibility of contestability.

**Geoffrey Brennan (Australian National University):** I'd like to make a point that is consistently overlooked in the privatisation debate. A characteristic of a public monopoly is that it's owned jointly by the members of the community, the proportions being determined by the tax structure and voting rights. The mere fact of privatising the monopoly — making the ownership rights salable on the stock exchange — provides a conventional static gain in efficiency terms. So, even if there were no gains at all in output markets, there would still be a presumption in favour of privatisation.

# **Macro Controls on Public Spending**

*Jon D. Craig*

Public Control on Public  
Spending

Jon Craig

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# Macro Controls on Public Spending

*Jon D. Craig*

## I. INTRODUCTION

In this paper I argue that 'bottom up' annual expenditure planning has contributed to the explosion of the relative size of the public sector in OECD countries. Many see the expansion of the public sector as placing a significant constraint on the growth potential of OECD countries via both the inefficient use of resources and the impact on incentives to work, save and invest.

If one agrees with that contention, there is a need for macro controls that place limitations on one or more of: expenditure levels; taxation levels; and borrowing by the public sector. Such controls allow the private sector to plan its activities; provide a discipline on politicians and public sector spending managers; and provide a performance measure for voters to judge elected governments.

The main criteria of a good macro control are:

- it must be easily understood, flexible and credible;
- it must have sufficient authority to impose discipline; and
- it must be backed by a financial implementation system capable of making the control targets achievable, including a system of multi-year expenditure planning and financial control.

I then look at experience in the US, UK and Australia with macro controls and conclude that:

- The Gramm-Rudman deficit reduction legislation has been helpful to the public debate in the US but has not yet proven it will provide an adequate discipline on public sector spending or the deficit. The absence of an implementation system is a significant weakness of the US system.

- After early failures, the UK has developed a reasonably successful set of macro controls in the Medium Term Financial Strategy operating since 1979. A key feature of the UK system is the existence of highly developed multi-year expenditure planning.
- The present Australian government's fiscal Trilogy has helped to provide a discipline on the public sector. However, the absence of a fully developed multi-year expenditure planning control system is a significant deterrent to further progress.

I conclude that control over the size of public sector spending, taxation and borrowings is really a question of political commitment. Without such commitment no progress is possible no matter what system is used.

However, provided the political commitment is present, macro controls provide a very useful weapon in the fight to achieve the desired objectives. Furthermore, given the difficulty of rapid change in public affairs, it is very desirable to develop a proper medium-term framework for expenditure, taxation and deficit reduction planning.

The final section of the paper makes some suggestions on desirable changes to the Australian budgetary process that would be consistent with these conclusions.

## **II. WHY DO WE NEED MACRO CONTROLS ON SPENDING?**

There is widespread concern among the governments of the OECD countries that their public sectors have grown too large and now constitute a significant restraint on growth. Between 1960 and 1983 the overall average ratio of public spending to GDP grew from about 30 per cent to almost 50 per cent. It seems most unlikely that the political leaders of the 1960s and early 1970s ever planned such a huge expansion. How did this state of affairs come about?

Part of the answer probably lies in overoptimistic assessments of growth opportunities in the 1970s and early 1980s. The rise of OPEC; the gradual erosion of labour and product market flexibility; and the secular rise in inflation expectations put paid to the growth rates to which politicians had become accustomed in the earlier post-war period. But political leaders were slow to recognise and accept these trends, and expenditure plans based on extrapolation of the past growth in national resources were not adjusted quickly enough to prevent an unplanned escalation of the public sector.

However, there was almost certainly a failure to exert proper control measures. Traditional 'bottom up' controls that focused on line-by-line

vetting of the annual input costs such as wages and office materials proved less appropriate as governments branched increasingly into the areas of welfare and industry assistance where they had little prior experience. Too often open-ended commitments were made to programs with little knowledge of the ultimate cost implications of those programs.

As the deep structural problems of the OECD countries have become evident in the 1980s, there has been an increased emphasis on the construction of medium-term policy frameworks intended to nurse their various economies back to health via coordination of fiscal, monetary, wage and other structural adjustment policies designed to enhance growth potential. Within the public sector this has involved a combination of one or more of the following macro controls:

- a multi-year public expenditure planning process that attempts to tailor growth of outlays to estimates of available national resources (as crudely measured by Gross National Product estimates);
- some commitment about taxation levels, either in terms of ratio to GDP, level of progressiveness of taxes including indexation of tax scales, or range and coverage of taxes;
- limitation on the overall size of public sector borrowings and consequent public sector debt levels.

Three main arguments can be adduced for macro controls. First, there is a need, in my view, to provide private individuals and businessmen with a basis for their own financial planning. Clearly defined and believable macro controls on public sector spending, taxing and borrowing may be able to create favourable expectation effects, which of themselves may provide a stimulus to private sector growth.

Second, there is a need to provide a discipline (or framework) for politicians and public sector planners. Unless some overall commitment to limit the size of the cake is made, there is no hope of focusing attention on the need to examine such worthy micro control topics as 'alternative options for achieving a specific goals' or 'maximising the benefits from a specific allocation'. There are many examples in Australia's recent history where planners (e.g. the Department of Urban and Regional Development under the Whitlam Government) have been allowed to develop grandiose schemes in a vacuum devoid of an overall spending framework and have then been forced, generally too late, to face reality — usually to the embarrassment of all concerned.

Third, a macro control mechanism provides a **performance benchmark**. As public concern over the size of the public sector grows, future governments will increasingly be judged by their performance in meeting the spending and revenue targets laid down in public pronouncements before and after elections. No longer will we be treated to long lists of new programs and benefits to improve our welfare. Instead, the accent in future election speeches will increasingly turn to sharing the sacrifices that must be made to meet macro targets. Of course, the buck does not stop there. Similar constraints will apply to lower level public sector managers who must be judged by their ability to live within macro control targets laid down by their political masters.

### III. CRITERIA FOR MACRO CONTROLS

While there may be fairly general agreement on the need for some overall macro controls on the growth of the public sector, the more difficult task is to formulate criteria that will make them successful. The more important requirements appear to be: public acceptance and understanding; the imposition of disciplines; and an implementation system.

#### **Public Acceptance and Understanding**

The macro control to be imposed must be easy for the general public to comprehend and must be seen as realistic and achievable. Those in the private sector must be able to use the macro control as a rule of thumb for their own decisions. It must be simple and sufficiently flexible to handle unforeseen developments, but it must not be so full of loopholes and qualifications as to render it meaningless.

Credibility is an overriding consideration if a macro control is to influence private sector expectations. It is one thing for politicians to promise restraint, but the private sector will be convinced (and make decisions accordingly) only if the goals set down can be achieved. The question of achievability is obviously in the eye of the beholder. However, if the government of the day can build an overall record of achievement, the problems of flexibility are lessened. The public will then accept small on-the-run adjustments where there is confidence that the overall spirit of the macro controls will be met.

#### **Imposing Disciplines**

The macro control targets must impose a discipline on a whole range of public sector actors: the Prime Minister and his Treasurer; the Cabinet;

the government as a whole; and the public service managers. As such, the macro control must have some authority. For a start, it must have the full and binding endorsement of the government. Second, there must be some mechanism to ensure that it is enforced (e.g. a Cabinet decision; a public manifesto; or some means to ensure that someone in authority will have the power to make it work). If the macro control is seen as merely a statistical projection or a constraint imposed by Treasury bureaucrats, it will never succeed.

### **An Implementation System**

It is one thing to have a meaningful goal and authority to back it up, but one must also have the technical capacity to produce results. There must be a system of detailed forward estimates backed up by detailed day-to-day financial controls to ensure that the macro targets are actually put into place at the manager level. A set of broad targets is of no use. They must be translatable into specific limits for each public sector manager to work within. Those responsible must then be answerable to parliament or some other authority for failure to meet targets. In short, the forward planning and financial control mechanisms must be totally integrated and operational.

## **IV. OVERSEAS EXPERIMENTS: THE UNITED STATES**

The US budget process has become incredibly complex and difficult to manage. The President presents a set of Budget Plans to Congress each February some eight months before the budget year commences in October. Those proposals are then debated exhaustively both in aggregate and in detail in the Expenditure Committees in the House of Representatives and the Senate. A compromise 'concurrent' resolution has to be hammered out between the two chambers of Congress. Subject to the concurrence of the President, that resolution ultimately becomes the basis for the Budget, which takes effect on October 1 (the calendar for the 1987 Fiscal Year (FY) Budget process is set down in the Appendix).

Experience in recent years has shown that this process allows every pressure group in the country an opportunity to put in objections to proposed cuts in spending, to new taxes, or to any other measure that might help to reduce the deficit. Given President Reagan's determination to reform the tax system, to stimulate incentives and to increase defence spending, and the equal determination of the Democrat-dominated Congress to maintain social welfare spending, there are enormous tensions to be resolved.

There is now bipartisan agreement that the deficit must be cut if serious economic problems are to be avoided. The problem is that nobody wishes to see his own pet programs suffer. There is classic confrontation between the micro analysis of programs — many of which may be justifiable in their own right — and the need for macro control on total spending and revenues for economic management purposes. If a crisis is to be avoided, the Executive and the Congress will ultimately be forced to sit down and agree on some priorities through a process of political compromise.

The immediate outlook is not good. In FY 85 the budget process virtually collapsed. The Budget was proposed by the President in February 1985, disputed throughout the northern summer, and adopted in August, but it disintegrated after the start of the FY on 1 October. Not one of the customary 13 appropriation bills was passed. Instead Congress had to resort to an omnibus spending bill, which provided sufficient funds to keep the government going. Essentially US budget policy is being made 'on the run', and the funding of government is continuously in dispute. That creates enormous uncertainties that are being reflected, *inter alia*, in increased volatility in financial markets.

Against that background, the Congress passed the so called 'Gramm-Rudman-Hollings' legislation (after the authors) designed to balance the federal budget by 1991. Passed in 1985, the legislation incorporates deficit targets each year and the specific actions required to meet those objectives. The aim was to put a 'gun at the head' of Congress to force it to make sensible decisions on priorities in order to reduce the deficit.

The main features of the legislation are:

- The US President is required to produce a set of budget proposals that meet the deficit targets set down in the legislation.
- The Congressional Budget Office (CBO) and the Office of Management and the Budget (OMB) are required to produce budget projections based on forecast economic growth and inflation rates that show the deficits (the average of the two sets of projections is used) that would evolve in the absence of policy action by Congress.
- If the projected deficit for FY 1987 exceeds the target by more than \$US10 billion and Congress and the President are unable to come up with alternative measures, the legislation requires a series of across-the-board spending cuts within a narrow set of spending programs. The programs affected cover only about 30 per cent of the budget since large sections of the health and welfare budgets are exempted.
- The original legislation then appointed the General Accounting Office (GAO) as the chief spending executioner; the GAO's role

was to coordinate calculations of the status of the deficit through the budget process and implement the 'automatic cuts' according to specific formulas decreed by Congress.

- The Supreme Court subsequently ruled that the GAO was an arm of the legislation (because Congress has the power to dismiss the Comptroller General of the GAO), not part of the Executive, and thus did not have the power to implement the cuts. (This ruling follows from Constitutional requirements for a separation of powers between the Executive and the Legislative.) A fall-back provision has therefore been adopted under which the GAO works out the cuts, which then have to be put into a resolution and voted upon by both chambers before they come into effect.
- The legislation also includes various rules to facilitate debate. To foil single issue meddlers who in the past tried to adorn the spending bills with concessions to the various interest groups they represent, proposed amendments to the Congress budget resolutions must be 'deficit neutral'; that is, anyone wishing to add spending to the resolution must offer either matching cuts elsewhere or revenue increases.

Gramm-Rudman has many detractors but it has served some purpose. In my view, the main success of the legislation has been to focus the debate and raise the level of public consciousness of the problems created by the large federal deficit and, more particularly, of the difficult but urgent measures needed to cut that deficit. That in itself could prove useful. At least there is some onus on those who would be prepared to let the deficit blow out to explain their position. Given the growing body of opinion on the consequences of such a course, the availability of some mechanism to focus debate could be beneficial.

The main query is whether Gramm-Rudman will provide an effective discipline on the Executive and the Legislative and a means of reconciling divergent aims. On this score, Gramm-Rudman has many deficiencies. However, it is still too early to write it off.

The real test will come in February 1987. The administration will present a budget for FY 88 that can be guaranteed to continue the defence build-up while raising no extra revenue. That will make it hard to hit the Gramm-Rudman deficit target of \$109 billion.

The detractors' criticisms come from two sides. On the one hand, commentators have focused on the provisions of the legislation whereby the entire revised deficit reduction process can be suspended should the administration determine that the US economy has grown by less than 1 per cent in two consecutive quarters. While most would concede the need for some flexibility, the availability of such 'let outs' could take pressure off the Executive and Congress just when some see it as likely

to be most needed. On the other hand, there are those who fear that the legislating of rigid targets could precipitate a constitutional crisis and a recession. For example, would the President be open to impeachment if the Executive ultimately decides it will not meet the targets? Similarly, if Congress finds it too hard will it not simply revise the law? Various scenarios can be painted here. For example, with the Democrats now controlling Congress, will they simply block action on the FY 88 budget knowing full well that operation of Gramm-Rudman will force large cuts in defence? Will the President then accept those cuts but seek to blame the 'neglect' of defence on the Democrats? Interesting times lie ahead.

Ultimately, the concept of fixed targets and automatic across-the-board cuts will almost certainly prove to be untenable. Decisive action to cut the deficit will probably come about only when there is an economic and political crisis that forces action. Only then will the necessary political compromises be made. However, in the US context the Gramm-Rudman initiative has probably proved helpful essentially because, as argued above, it has provided an avenue for grass roots opposition. The fact that it cannot do more mainly reflects the difficulty of controlling spending in an environment where the Executive and Legislative powers are separated rather than an inherent weakness of the concept itself.

Of course, even if the problems outlined above were overcome, the absence of an established procedure for implementing the cuts required remains a major stumbling block. Arrangements that call for the General Accounting Office (a group of public servants controlled by Congress itself) to identify the necessary across-the-board cuts are not really tenable. The legislators know that but cannot force a more logical cutting process on themselves. The Executive's budget agencies, mainly the OMB and the Congress Secretariat (the CBO), are the main bodies that will have to design a logical cutting process. The GAO could then have a role in implementing those cuts, but one is left with the impression that the US suffers badly from the absence of a single policy coordination department such as the UK Treasury. Again that is largely a function of the separation of powers, which mitigates against a strong Executive control over spending priorities.

## V. OVERSEAS EXPERIMENTS: THE UNITED KINGDOM

### **The Public Expenditure Survey**

The UK's Public Expenditure Survey (PES) has attracted a good deal of public attention. Many international observers were initially charmed by the system in the 1960s and early 1970s because they saw its potential

to provide ministers and their advisers with an overall system of planning and control that was quite unique at that time.

However, most would agree that early experience with the system was very disappointing. The record of public expenditure control in the UK during the 1960s and early 1970s was abysmal. Between 1960 and 1983, total outlays increased from about 33 per cent to 47 per cent of GDP. Much of that increase occurred in the decade from 1966 to 1976 when outlays expanded from 35 per cent to 46 per cent of GDP. This expenditure growth, and the large increase in public borrowing that came with it, contributed to a series of balance of payments crises and culminated in the UK being forced to enter a borrowing program with the IMF in 1977. The Thatcher Government has made some progress in holding down the growth of public expenditures, but the ratio of expenditure to GDP remains high and many critics have emphasised the role of public sector assets sales in the Thatcher Government's progress in reducing the Public Sector Borrowing Requirement (PSBR).

The concept of macro expenditure control on spending grew out of the Plowden Committee in 1961, which advocated, among other things, greater attention to planning expenditure needs in the context of medium-term assessments of the economy. The initial exercises were conceived purely as indicative surveys with no particular status, but they have evolved through hard experience into an integral component of the budget process and an important mechanism of expenditure control.

The PES planning period now covers four years: the current financial year (as a base) plus three forward years. Customarily, Cabinet endorses guidelines and objectives at the outset of the annual PES exercise. The survey begins with a projection of existing program levels extended to the end of the financial year. The set of approved programs, modified by any later policy changes and by an agreed allowance for demand-led expenditure, thus constitutes a baseline for the three forward years of the survey.

Although the process may vary from year to year, the next step in the survey generally includes the preparation of departmental bids for funds in addition to the baseline and off-setting savings or options for future reductions. These bids and options are set out in a report prepared jointly by Treasury and the spending departments' officials, which is then submitted for Cabinet consideration.

On the basis of the PES figures, Cabinet targets public expenditure totals for the next three years. Their deliberations focus in particular on the figures for the immediately impending financial year, as it is from these targets that the more detailed supply estimates are derived. After a series of Cabinet debates — and bilateral negotiations as necessary between the Treasury Minister and individual spending ministers — the

final decision of the full Cabinet is published in the government's Annual Public Expenditure White Paper.

Why did the relative size of the public sector grow so rapidly in the early years of the PES? Several factors appear to have been important.

**Overoptimistic assessments of economic growth.** Successive governments in the 1960s and early 1970s adopted overoptimistic economic growth targets. Announced spending plans tended to become commitments and could not be easily adjusted when the growth in national resources failed to live up to expectations. For example, the National Economic Development Council, set up in 1963, adopted a five-year GDP growth target of 4 per cent a year, and Treasury was obliged to accept expenditure plans based on that assessment. In the event, real expenditure was kept to an annual growth of 4.1 per cent but GDP fell well short of target. The result was a ratcheting up in the relative size of the public sector.

**Incrementalism.** During the early years of the forward planning exercise, there was a tendency to give less scrutiny to existing policy programs. Once a program was in place, the onus was on Treasury to prove that the costs were excessive. The argument tended to be over the size of the increase rather than whether the program was achieving objectives; whether it should be rationalised or reformed. The open-ended nature of many programs adopted in the 1960s and early 1970s made them particularly difficult to control. The Treasury and the departments themselves found themselves committed to costs that had never been anticipated when the programs were conceived.

**Inflation.** The forward expenditure programs were drawn up in 'volume' or constant price terms. There was therefore an implicit understanding that the cost of the programs would be escalated in line with inflation. There are a number of problems with that approach. First, the overall average 'productivity' of public sector activities, while never measurable directly, is almost certainly below that of the private sector as a whole. As such, the 'price' of public sector goods can normally be expected to increase more rapidly than the national inflation rate (as measured by the GDP implicit price deflator). In order to ensure that the cash cost of public sector outlays in outturn prices does not grow faster than the comparable measure of GDP, it is therefore necessary for real public sector outlays to grow *more slowly* than real GDP, as per the example presented in Table 1.

As can be seen from this hypothetical (but not unrealistic) example, in order to hold the relative size of public outlays at 25 per cent of GDP in money terms (Row 5), the real growth in public sector outlays in 1981-82 must be held to about 1.8 per cent compared to an overall growth in real GDP of 3.5 per cent. This is because the relative price of public sector activities (Row 8) increased by 1.7 per cent, faster than the national price deflator.

Aside from this statistical issue, a more fundamental objection to planning in real or volume terms is that it removes a discipline on expenditure control from administrators. If the volume is underwritten, there is no incentive to control the amount paid for goods, to bargain for the best price, to carefully scrutinise contract claims, to bargain with public sector unions. Worse still, it may leave the door open to the less scrupulous to pass off as price increases, expenditures that in practice are volume related. This is particularly so where issues of quality are important; e.g. if the price of a computer goes up is it because the basic cost of computers is increasing or because the computer purchased has newer chips, software, etc?

Table 1  
Hypothetical Example of Public Spending Planning In  
Real Terms (\$m)

	1980-81	1981-82
(1) Money GDP at Outturn Prices	100 000	112 000
(2) Real GDP	100 000	103 500
(% Change Yr on Yr)		(+3.5%)
(3) Implicit Price Deflator (1980-81 = 1.000)	1.000	1.082
(4) Government Outlays at Outturn Prices	25 000	28 000
(5) Ratio of Public Sector/GDP Row (1)/Row (4)	25%	25%
(6) Government Outlays at Constant Prices	25 000	25 455
(% Change Yr on Yr)		(+1.8%)
(7) Implicit Price Deflator (1980/81 = 1.000)	1.000	1.100
(8) Relative Price Deflator Row (7)/Row (3)	1.000	1.017

**Lack of monitoring and intrayear controls.** For many years, the UK Treasury lacked a means of monitoring monthly expenditures. By the time expenditure overshooting (or undershooting) of budget estimates became apparent it was often too late for anything to be done about it.

**Lack of integration into annual budget control process.** The forward expenditure planning process was largely independent of the

annual budget process. The presentation formats were different; the price basis was different; and the coverage of the estimates was different. As a result it was particularly difficult for parliamentarians to understand, let alone debate, forward expenditure plans and controls over that spending.

### **The Post-1976 Changes**

The balance of payments crisis and subsequent IMF borrowing program arranged in the period 1976-77 led to a number of changes in UK public spending. The emphasis on planning within medium-term assessments was changed to an emphasis on financial control. More realistic and shorter-term growth targets were formulated; there was greater scrutiny of existing programs; and steps were taken to correct weaknesses in the financial control system.

A major step in this last mentioned context was the introduction of a system of annual cash limits in 1975. For the first year of the planning period, the government forecast prices and wages growth; cash limits for broad expenditure blocks were then formulated which were consistent with the planned volumes of expenditure (i.e. labour and material inputs). The block concept was intended to provide some flexibility since it allowed overruns in one area to be compensated by undershoots in other areas. Strictly annual cash limits were to have priority over the volume planning estimates, so that if a department found it was likely to exceed its cash allocation, the volumes were to be squeezed via cutbacks in services, etc. Obviously this was not always possible, and in any event cash limits did not cover social welfare payments where expenditure depended upon the number of beneficiaries and the prescribed rates. They also did not apply to local authorities. All told about 40 per cent of total outlays were covered by cash limits.

A second reform was the establishment of a Financial Information System. For each program, administrators were asked to work out expected profiles of expenditure over the planning period. For the first year, the profiles were to be consistent with the block of programs covered by the cash limit. Regular monthly returns were then required during the year so that Treasury could monitor actual progress against expected profiles to try to get an early warning of slippage in programs.

Third, there was a comprehensive revamping of the annual supply estimates provided to parliament. Supply votes were recast and regrouped according to the functional presentation categories used in the forward expenditure planning exercise and the 'blocks of expenditure' subject to cash limits were identified. In 1984, for example, the supply vote contained 183 expenditure categories of which 118 were subject to cash limits. If a department expects it may breach its cash limit it must now seek parliamentary authority for the excess spending and have the money voted via supplementary estimates.

Fourth, in 1981 the Conservative government moved to plan all future year expenditures in cash rather than volume terms.

### **Medium Term Financial Strategy**

The present Conservative government has reinforced this emphasis on financial control by formulating spending plans within a Medium Term Financial Strategy (MTFS), which was designed to reduce inflation and interest rates by means of reductions in the Public Sector Borrowing Requirement (PSBR) and the rate of monetary growth. Each year, the government has announced medium-term PSBR and monetary targets. A medium-term cash expenditure target is also established. The targets have been revised from year to year in the light of developments during the previous year.

Although there has been considerable slippage in the MTFS (see Table 2 for the performance in relation to the PSBR) it has added an extra dimension to the macro control mechanism in that there is now explicit consideration of revenue prospects and the consequences for public sector borrowing.

How well does the MTFS measure up to the three criteria mentioned earlier?

**Public awareness and private sector response.** There can be little doubt that the MTFS provided the business community and the public generally with an excellent perspective on the government's objectives. Subsequently, inflation has been brought down, interest rates have fallen and growth has picked up somewhat. Just how much of that is due to the MTFS is impossible to judge. While UK performance remains pretty dismal, with unemployment still at post-war highs, some would argue that the situation would have been even worse in the absence of the MTFS. However, others would argue the mediocre performance reflects slippages in the MTFS. Most would agree that the MTFS has served to provide a useful framework for debate.

**Discipline.** By any measure, the performance of the monetary aggregates and PSBR under the MTFS has been disappointing. However, some of the slippages in the PSBR have owed much to events beyond the government's direct control (e.g. the slowdown in the world economy in the early 1980s, the coalminers' strike, and the fall in oil prices). Within the PSBR aggregates there has been some success in containing public expenditure, which has averaged a little over 1 per cent in real terms in the period. The horrendous control problems of the late 1960s and early 1970s have been overcome, but the government has made only limited progress in winding back the 'rump' of spending programs in the social welfare area.

Another disappointment has been the emergence of 'cheating' in the form of large asset sales. Since asset sales are defined as negative

Table 2  
 Medium Term Financial Strategy Projection and Outturn (% GDP)  
 PSBR Estimates

		79-80	80-81	81-82	83-83	83-84	84-85	85-86	86-87	87-88	88-89
Budget Paper Estimate											
250	Jun 79	4.50									
	Mar 80	4.75	3.75	3.0	2.25	1.25					
	81	5.0	6.0	4.50	3.75	2.0					
	82										
	83		5.70	4.25	3.50	2.75	2.0				
	84			3.50	2.75	2.75	2.50	2.0			
	85				3.30	3.25	2.25	2.0	2.0	1.75	1.75
	86					3.20	3.25	2.0	1.75	1.75	1.75
Actuals		4.80	5.60	3.40	3.20	3.20	3.10	1.70			

expenditure in Public Expenditure White Papers, they have made a significant contribution to reducing the PSBR. The problem is that such sales are just another form of financing the deficit. They do not increase national savings; they are of a once-for-all nature and do not contribute to permanent reductions to the public sector's demand on resources. Moreover, if the enterprises concerned remain monopolies requiring regulation it can be argued that the degree of public sector involvement is little reduced — there has just been an accounting change.

**Implementation system.** The strong point of the UK system compared to other countries is the detailed planning system and associated financial controls outlined earlier. If the political will to control spending were present, it is difficult to believe now that the task would founder on the basis of inadequate systems.

## VI. AUSTRALIAN EXPERIENCE

The present Australian government has attempted to impose a macro control on the public sector via a Trilogy of promises designed to provide a medium-term framework of fiscal discipline within an annual budget cycle. The emphasis is on containing the growth in government expenditure and borrowing, without recourse to a structurally higher tax burden. Briefly, the Trilogy announced in 1984 stated:

- Commonwealth government expenditure was not to increase as a proportion of GDP in 1985–86 nor over the life of the parliament (i.e. to 1987–88);
- the budget deficit was to be reduced in money terms in 1985–86 and as a proportion of GDP over the life of the parliament; and
- there was to be no increase in tax revenue as a proportion of GDP in 1985–86 nor over the life of the parliament.

These three promises undoubtedly constitute a major break with the past. No Australian government has ever imposed such a public restraint on itself. The Trilogy commitments were applied in framing the 1985–86 budget. Notwithstanding an overrun on outlays and the deficit, the ratio of outlays to GDP fell from 30.4 per cent to 30.1 per cent and the deficit was reduced from 3.2 per cent to 2.5 per cent of GDP. The ratio of tax receipts to GDP was 25.2 per cent in 1985–86, up only fractionally from the 1984–85 level.

Although the Trilogy does not apply specifically to 1986–87, its promises have been overachieved in respect of expenditure and the deficit but broken in respect of taxation. Assuming GDP of around \$254

billion in 1986-87 the respective ratios to GDP will be 29.5 per cent for total outlays, 25.9 per cent for total taxes and 1.1 per cent for the deficit.

How does the Trilogy match up against our criteria?

### **Public Awareness and Private Sector Response**

The motivations behind the announcement of the Trilogy are obscure. Perhaps the government wanted to put paid to fears that the experience of the Whitlam era would be repeated; perhaps the commitment was meant to place a discipline on ministers and back bench factions; perhaps it was a genuine desire to re-orient the economy towards private sector growth after an initial public sector fiscal surge in the first years of government. However, there seems little doubt that the Trilogy played an important role in encouraging a belief among business leaders and the public generally that the Labor government would behave in a fiscally responsible manner.

Unfortunately subsequent economic developments, including a further decline in our external terms of trade, cast doubt upon the adequacy of the Trilogy. For that reason the government has moved away from its commitment. Nevertheless, the importance of the commitment can be seen in the Opposition's 1986-87 budget response when their leader stated: 'On our election to office, the coalition government will set expenditure and taxation limits that are significantly more rigorous than those of the present government's trilogy'.

While the government now appears to be committed to holding taxation revenues at about their present ratio of GDP, it will attempt to make further efforts to cut expenditure in order to balance its budget by 1988-89.

It is impossible to judge whether the Trilogy and its subsequent modifications have had a favourable impact on private sector behaviour. The current depressed near-term outlook for the private sector relates to a number of developments here and overseas. Who is to say the expectations would not be even worse in the absence of some fiscal commitment at the macro level?

### **Discipline**

The main benefit of the Trilogy has been in providing a discipline on outlays. Officials are unstinting in their praise of the Trilogy in holding down outlays. Although the 1986-87 Budget outlay targets were initially formulated on the assumption that GDP growth in 1986-87 would continue at 3-4 per cent, the outlays target was tightened further and revenues were increased when it became clear that that growth objective would not be met.

Arguably, this tight discipline would not have been effective if the Australian dollar had not plunged below US60c in the weeks leading up to the delivery of that budget. However, it does seem that the Trilogy was important in the early budget preparation and that it helped provide a framework for containing outlay growth and set the environment for the government to take the additional steps towards the zero real outlay growth objective attained in the 1986-87 Budget. Without such a framework the final scramble may not have been possible.

Similarly, the commitments made now in relation to overall taxation ratios will provide a basis for setting the initial expenditure targets for the 1987-88 budget (which will be formulated prior to the rest of the budget) and in that sense will provide at least some administrative guidance for departmental managers — guidelines that had previously been totally lacking.

### **Implementation Systems**

The main weakness of the Trilogy was that it had to be taken on trust. There is no tangible evidence that the government had thought through the detailed medium-term fiscal (or other) implications of its promise. That lends support to the sceptics in financial markets and handicaps efforts to reduce interest rates. In this context, the absence of a fully developed system of forward expenditure estimates may be seen as contributing to a possible credibility gap for the government.

At the time of writing this article, the three-year forward estimates of expenditure left something to be desired. The estimates were more in the nature of statistical projections than a firm indication of government spending intentions. The deficiencies are as follows:

- The estimates are not yet fully integrated into the budget process. Hopefully this is to be changed in 1987-88 and departments will be asked to update the estimates previously provided in earlier rounds and explain variations from earlier estimates rather than treating each round as a new starting point.
- The base estimates cover only approved ongoing programs, with allowances for lapsed programs or 'technical' new policy. Technical new policy covers those programs for which formal authority will lapse during the next three years but that can nevertheless be regarded as representing unavoidable commitments that will require funding.
- The price basis of the original estimates collected from departments varies. For some items a volume or constant price basis is used, but for others a money amount is used. On occasion the money amount already includes an allowance for

price increases. Although the Department of Finance publishes all estimates in outturn prices, some doubt must remain on the accuracy of the adjustment methods used. Moreover, last year we were not given an estimate of the overall inflation rate used in preparing the projections.

- While considerable progress has been made on improving the quality of the estimates, they do not appear to receive the same degree of vetting as the annual estimates.

In short, while the current forward estimates exercise provides a potential framework for implementing the fiscal strategy, it could not fill that role in its present format. What is needed is a fully articulated set of government-endorsed estimates that show how new policies would fit into agreed money targets. The Department of Finance is certainly aware of these problems and it is to be hoped that we will see the results of their endeavour in the year ahead.

## VII. SOME GENERAL OBSERVATIONS ON MACRO CONTROLS

Restraint of public sector outlays, revenues and borrowing is ultimately a question of political commitment. The countries that have had most success tend to be those that have experienced external account crises (e.g. the UK, Denmark) or have an electorate conditioned by past experience to resist public sector growth (e.g. Japan, West Germany).

Where political commitment is lacking, no macro control mechanism will be effective. It is obviously difficult for politicians, who have a relatively short-term horizon, to enter into the medium-term commitments that are often seen as essential to attain an orderly restraint on the public sector. There are immense pressures on politicians to avoid taking decisions before they are necessary or even announcing their intentions to consider a contentious decision. These factors work against detailed decisions on multi-year expenditure plans or on future taxation changes.

Nevertheless, where a country reaches a crisis stage and faces no alternative but to act, traditional political attitudes can be changed because the crisis creates a setting in which it is seen as responsible to tackle the nation's problems head on.

In this context, macro controls become a valuable aid. In my view, the best control is one that encompasses expenditures, revenues and borrowings since each is important. Experience overseas (e.g. in the UK) suggests that efforts to control expenditure in isolation do not impose a sufficient discipline. While forward revenue estimates are very hard to make, it is salutary to set down relative magnitudes on different

economic assumptions and to calculate the borrowing implications that flow from them. The macro expenditure controls are probably best set in absolute cash terms (as per the UK), but revenue and borrowing targets are better set relative to an economic aggregate, such as nominal GDP, to which they are ultimately related.

Of course, the economic estimation problems are immense, and it would be foolish for governments to rigidly adhere to decimal points in their targets. Moreover, conditions do change and nobody would suggest it was feasible, for example, to achieve a balanced budget where the economy fell suddenly into a major recession. The key to success is therefore adherence to the spirit of the control. If governments can indicate that they are putting in place policies based on realistic assumptions; if they have detailed back-up plans to support those policies; and if they can convince the people that they will hold to the broad thrust of policy over time — then they will gain acceptance even if the final outcomes differ from plans.

Aside from the obvious political dangers of embarking on medium-term macro controls, officials often point to economic and social dangers. The analogy of monetary targets is often raised. Deregulation has made it very difficult to interpret monetary aggregates, and monetary authorities around the world have seized this opportunity to scrap monetary targets. One has to carefully weigh the benefits and costs here. While nobody would deny the difficulties, there can be no doubt that the abolition of targets has suited the ends of politicians and administrators alike. In many countries, there was a desire to ease back on monetary policy for economic reasons while officials found the constraint of targets distasteful.

However, we must be careful of throwing out the baby with the bathwater. It is just too convenient to let politicians and administrators off the hook. If targets are inappropriate there should be some onus on them to explain why that is so. If there are believable explanations, then misses on targets (or revised targets) will be accepted.

### VIII. IMPLICATIONS FOR AUSTRALIA

Many believe that Australia now faces economic problems that will take many years to resolve. That will require a medium-term policy framework. The present government's Trilogy, and its subsequent modification to taxation/GDP targets, does provide a starting point.

What is lacking is a framework for debate on how to achieve it. Private sector participants are asked to 'trust' that the government will achieve its targets. Past performance helps to build trust (and the present government does have credibility here). However, it would be useful if

there was some more tangible evidence that our governments had thought through how their macro targets could be implemented.

To that end, I would like to see the following changes.

1. Aggregate three-year expenditure cash targets should be set. To me, the idea of linking expenditure to GDP is not well founded. Expenditure should be related to perceived needs, which are not necessarily related to GDP.

2. Supporting revenue and deficit targets should be set down on the basis of assumed GDP growth targets.

3. The forward estimates of expenditure should be revamped:

- The estimates should be fully integrated into the annual budget cycle (as per earlier discussion). This would mean initial collection in say March/April each year and continuous updating throughout the year in the light of policy changes, price changes and other economic developments.
- Estimates of ongoing policy should be refined and presented to Cabinet in the May/July period along with savings options and new policy proposals.
- When the budget is presented in August it should contain estimates of the projected cash outlays in each of the two subsequent years, together with a contingency reserve for new policies yet to be adopted.
- Revenue projections based on existing taxation structures should be published based on projected growth and inflation assumptions.
- A ready reckoner showing the implication of alternative growth and inflation assumptions for expenditure and revenue projections should be shown.

Every observer could then sit down and calculate his own assessment of the future fiscal outlook depending on his or her view of world.

I am sure such proposals would be opposed by politicians and bureaucrats alike. The familiar objections would emerge over the difficulties of estimating; the dangers of locking oneself into future commitments if conditions change; the unrealistic expectations that may be created; the stupidity of trying to force decisions before they are required; and the fear of disillusionment if changes become necessary.

Having sat in a bureaucratic seat I am aware of the possible dangers involved, particularly in earlier years when there was enormous pressure to expand the size of the public sector. However, I believe conditions have changed. The external constraint we have built for ourselves will be with us for many years. What we need now is a realistic bipartisan debate on how we can resolve the fiscal problems, which have had such a key role in creating that external constraint.

Appendix  
**Fiscal 1987 Congressional Budget Process**

<b>Deadline</b>	<b>Action to Be Completed</b>
5 Feb 1986	President submits budget to Congress.
15 Feb 1986	Congressional Budget Office submits report and projections on the budget outlook to the Budget Committee.
25 Feb 1986	Committee submit their 'views and estimates' to Budget Committees.
1 Apr 1986	Senate Budget Committee reports Congressional budget resolution to Senate.
15 Apr 1986	Congress due to complete action on concurrent budget resolution.
15 May 1986	Annual Appropriation Bills are considered in the House — even if the concurrent budget resolution has not been passed.
10 Jun 1986	House Appropriation Committee must report final annual Appropriations Bill.
15 Jun 1986	Congress completes joint action on reconciliation legislation from Congressional budget resolution.
30 Jun 1986	House completes action on Annual Appropriations Bills.
15 Aug 1986	Office of Management and Budget (OMB) and Congressional Budget Office (CBO) present budget 'snapshot' of the latest outlay, revenue and deficit projections.
20 Aug 1986	OMB and CBO send a report on the deficit to the General Accounting Office (GAO).
25 Aug 1986	GAO issues report on the deficit to the President.
1 Sep 1986	The President issues a preliminary 'sequester' order to Congress, if needed, requiring measures to meet the budget targets.

### *Restraining Leviathan*

1 Sep 1986 – 30 Sep 1986	Congress reviews sequester order and has one month to develop an alternative deficit plan.
1 Oct 1986	Sequester order takes effect and fiscal year begins.
5 Oct 1986	OMB and CBO send revised report on deficit to the GAO.
10 Oct 1986	GAO issues revised report on deficit to the President.
15 Oct 1986	Final sequester order.
15 Nov 1986	GAO issues compliance report.

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**Policy Termination and  
Innovation: Making Leviathan  
Agile**

*Scott Prasser*

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# Policy Termination and Innovation: Making Leviathan Agile

*Scott Prasser*

## I. INTRODUCTION

The area addressed by this paper concerns the cornerstones of government, big or small: the bureaucracy and public policy. Stress is given to the operational norms of public sector management, the processes of policy development, and the reality of the political system in which they work. It is the contention of this paper that only if these issues are appreciated, only if we can make governments, and in particular the bureaucracy, more able to respond to changing circumstances, and only if we can design policy with change in the future more in mind, will government remain small. Whether small government as an end in itself is desirable is not the concern here. Rather, the reality is that there is both a growing demand from the community for less government, and a basic economic fact that the prosperity of the past can no longer finance all our dreams, however good they may be.

The approach of this paper may be justified in three main ways. First, attempts at reducing or restraining the size of government in Australia and overseas have not been very successful. In the United Kingdom under Thatcher public spending as a proportion of GDP has increased, public sector employment in some levels of government has risen, and many of the planned expenditure cuts have failed to materialise (Levacic, 1985). Reagan has not been very successful in the United States, as the growth of the federal deficit clearly shows and if the opinions of David Stockman, the former Director of the federal Office of Management and Budget, are worth believing (Stockman, 1986). Too often governments are simply unwilling to face up to the economic realities of essential downward adjustments in their expenditure proposals. Instead, such governments indulge in fairy-tale series of

'cuts', which involve putting off hard decisions, fudging budget figures, freezing instead of reducing staff levels, borrowing, or changing the budget rules to redefine 'deficits'.

Australia has not done much better. In the 1986-87 Federal Budget \$1.1 billion of the proposed \$2 billion in 'cuts' were in fact made up of minor postponements of existing and continuing programs. While the Fraser Government was more successful than its predecessor in reducing the rate of growth of overall government expenditure, it still fell short of actual reductions. Its Razor Gang exercise of 1981 was correctly seen as a mainly symbolic exercise, since many of its proposals were delayed or eventually cancelled because of political reaction (Simonas, 1982).<sup>1</sup> Australian States have hardly been shining examples of restraint, including those like Queensland that espouse a 'small government' line. In fact, Queensland has experienced higher than average rates of public sector employment growth and increases in public charges. Between March 1983 and March 1986 Queensland's government employment grew by 9.7 per cent compared to the Commonwealth's 3.9 per cent, South Australia's 3.0 per cent, and Tasmania's 1.5 per cent decline. In terms of State and local government charges, those in Queensland rose by 31.7 per cent between 1983 and 1986 compared to the eight-capital weighted average of 25.2 per cent.

A second reason why more attention needs to be given to the overall operations of the public sector is that macro strategies to achieve small government, such as the Trilogy or constitutional limits on the size of a budget, may not prove successful. Other papers in this volume comment on these approaches so we should not be too negative. However, Allen Schick (1986:133) concluded that these macro approaches should not be seen as the total solution:

Fiscal norms, spending targets, multiyear controls and other constraints do not suffice to reorient budgeting from growth to retrenchment. It is also necessary for government to follow up these macro actions with restrictive budget decisions on specific programmes.

Schick might also have suggested more attention to the way public policies are designed and implemented.

Finally, there is growing dissatisfaction with existing mechanisms of expenditure control within government itself, with the various external agencies like parliamentary committees and auditor-generals, and

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<sup>1</sup>For example the decision to sell the Commonwealth's clothing and ordnance factories at Bendigo caused considerable protest activity and resulted in a special Senate Committee inquiry, which recommended against the sale.

with new techniques like zero-based budgeting. British civil servant Leslie Chapman (1978) sadly chronicles how his highly successful efforts at reducing government waste in his particular section were not adopted by the rest of his department or the civil service, despite ministerial support and parliamentary committee involvement. These various control mechanisms appear to be inadequate, perhaps because they are too entwined in the political system to be effective. Even special agencies like the Grace Commission on Waste in the United States are of limited value because they frequently misinterpret or misunderstand the operations of the public sector and the political system (Peters, 1986). Appreciating this point, a report prepared for the Committee for the Economic Development of Australia (CEDA, 1986:2) doubted 'whether the measures now being applied by the Government — or contemplated by the Opposition, will be adequate' to control expenditure.

Similarly, small government will not be achieved by the exhortations of some community leaders for whole departments to be abolished, mass sackings of public servants, 'policy freezes', and total withdrawals from a range of policy areas (Barnett and Farmer, 1986; 'Elliott tells Libs', 1986; see also B. Buckley's report for the Australian Institute for Public Policy reported in *The Age*, 4 August 1986). This approach misunderstands the nature of the public sector, our political system and the complexity of public policy. It treats the symptoms of the disease rather than the causes. Such brutal calls for cuts might do much to raise morale and enthusiasm among small government advocates, but out in the field of democratic political reality the rules are different and the opposition in terms of the bureaucracy and large sections of the electorate tougher. What the advocates of small government must do is concentrate less on grandiose plans that deny the operating norms of our system, and more on making government more able to cope with demands without resorting to more resources.

## II. SOME CAUSES OF GOVERNMENT GROWTH

The growth of government has not just been imposed on the electorate, but is partly the result of electorate demands, as each party tries to outbid the other in the political market place by promising more for less. This, said Samuel Brittan, is one of the contradictions of our political system, which is characterised by 'a process of political competition which imparts a systematic upward bias to expectations' (Brittan, 1975:141). Calls for drastic cuts would be political masochism for the elected official and will therefore not be heeded. An approach is needed to allow politicians to terminate certain policy areas without terminating themselves at the ballot box.

What partially allowed this process of expansion to continue was the long period of economic growth most Western nations have enjoyed since World War II. This growth affected both politicians and public sector managers in their approach to public policy and the management of organisations. Economic growth meant that there were resources to distribute. For the politician the task was really one of distributing the largesse of prosperity and buying consensus by ensuring everyone got something. Economic and expenditure growth was the glue holding society together. Growth also made life easy for public sector managers and affected their way of operating. All programs grew incrementally, and there were also extra resources at the margin for something new. There was no need to review old programs; the budgetary system did not reward savings in any case. Career success was based on keeping one's share of the budget cake, not terminating programs. Moreover, in these times it was easy to accommodate incompetent or redundant staff by relocating them in a department where they did no (or less) harm. Thus, incompetent social workers and teachers could be taken out of the front line and given clerical duties, and a new influx of recruits would take their places. Growth allowed good staff to be rewarded as there were always new higher positions being established in expanding organisations. Morale could be easily maintained and interorganisational disputes minimised as everyone, including less important departments, got something.

An obvious manifestation of this whole process has been the growth of more and more public departments, bureaus, statutory bodies, commissions and specialised agencies. These reflect the extension of government into most areas of life. More importantly, their establishment and general immortality (Kaufman, 1976) is symbolic of the policy process in our system of government. With changes in government, new organisations are established not only to administer new policies, but also to counteract existing ones initiated by previous governments (for discussion of organisational changes during the Whitlam and Fraser Governments, see Reid and Lloyd, 1974; and Scotton and Ferber, 1980). Because policies and organisations develop their own supporters — not only their staff but also their clientele receiving services — termination is difficult, so in times of growth it is politically easier to duplicate existing structures. This process of accretion makes coordination, communication and changing direction increasingly difficult. A recent example of this is the recommendation by the Better Health Commission, a federal inquiry, that despite the existence of a number of organisations, preventive health proposals will be achieved only if a new national body is established to 'provide leadership' (Better Health Commission, 1986:155-6). Even organisations established for symbolic reasons with few resources soon learn how to redefine their roles, expand their boundaries and gain access

to more resources. The Human Rights Commission is an example of this.

Advocates of small government seem remarkably unaware of these political and administrative realities. They seem unable to comprehend how even in hard times (no resource growth) government grows. Part of this lack of understanding stems from the confusion in applying private sector concepts and management styles to public sector situations. Not only are there the political and bureaucratic factors to appreciate, but even some of the basic maxims of good management seem difficult to apply. For instance, the private sector can gauge success by sales, profits and market shares. It is easy to identify poor policies (or products) — they are the ones that do not sell. In the public sector this is not so easy. Indeed, the public products generating too much demand (e.g. pensions with no limiting guidelines) might be seen as failures. Again, in the public sector, goals are less clear and hence performance less measurable. This partly reflects the policy formulation process, which tries to meet a number of contradictory expectations over short- and long-term perspectives. Governments prefer ambiguity because it means they can be criticised less for failure.

This is why 'programme budgeting' has not been the success that many predicted. Setting objectives, developing measures of success and all the other paraphernalia of programme budgeting is such a difficult process (for analyses of the limitations of programme budgeting, zero-based budgeting and sunset legislation, see Wildavsky, 1969, 1973; Clyne, 1979; and Brewer, 1978). Success in the public sector is often about obeying procedural rules (accountability), or it is redefined in terms of quantifiable indicators such as the number of hospitals built or cheques posted rather than whether the nation's health actually improved.

For these reasons, termination in the public sector is more difficult than in the private sector. Not only does the private sector have better indicators of failure, but once decided, termination involves fewer interests. It usually involves only the company and its employees. Also, someone else can start up production. In contrast, the public sector is a monopoly producer — a position it holds because no one else wants the task. Its terminations will involve not just its staff, but also the recipients of the policy — the clientele. They have no alternative source and will fight more earnestly against termination. Moreover, the social nature of public policy, the lack of definite measures of success and failure, and the overriding importance of a range of different values will make change or termination harder to defend (for more discussion of this private-public comparison, see Behn, 1980; and Capuiolo and Dowling, 1983).

All this might appear elementary, but it indicates that to make small government something more than a popular slogan, some considerable thought needs to be given to the fundamental assumptions,

processes and realities of our political system. It is no use resorting to economic formulas or some broad process approach to make the disparate parts of the government system act in a rational way. Rather, some more realistic suggestions that can be grafted onto our system of government, rather than turning it upside down, are needed. To use a nautical analogy, what we have now is a ship of state that, like a boat at sea, is wallowing in a swell of fiscal restraint. It is overloaded, unwieldy, unresponsive, top-heavy, overmanned and about to capsize. To avert disaster some of the cargo now rotten with age must be jettisoned. The remaining load must be redistributed for better balance. The crew must be retrained to improve performance and to do different tasks. No new hands need apply. Moreover, the captain must gaze less at the distant horizon, stop searching for 'Treasure Island', and refocus attention on what is happening on the lower decks to ensure everyone is pulling in the same direction with the same effort. His task is to look more closely at what lies immediately ahead. Less pace will make avoiding a collision easier. In short, the ship of state should not be scuttled, or its crew made to walk the plank. All the passengers and cargo would then be lost. Rather, it needs to ride higher in the water, tauter and more responsive to the tiller so that it can better cope with the changing winds of political demands, and the rough seas of limited financial resources.

### III. SOME PROPOSALS

One way to make government more agile, and therefore less inclined to grow, is to adopt an environmentalist's view of public policy and government organisations. This does not mean conserving everything including dead wood, but rather it emphasises a culling process so that the majority of the trees in the forest will survive. It means recycling existing policies and organisations to meet different objectives in the same area, rather than creating new ones. This approach of 'policy succession' reflects the view that because government is already in most areas, genuine policy innovation is rare (see Hogwood and Gunn, 1984; and Hogwood and Peters, 1983). Policy succession is harder than innovation because there already are existing policies, producers, structures and clients in place who are going to miss out in a change in policy direction. Policy succession is not incrementalism, which involves small shifts in the same direction based on the same set of assumptions. Rather, it is a fundamental change in policy direction, using existing resources.

Policy-makers should be giving more consideration to allowing public policy and organisations to change — in other words to making succession easier. Too often policy-makers build monuments to

themselves. Too many policies, and their processes of implementation, are set in concrete and kept in place by legislation and special organisational structures. Client pressure, professional group self-interest, combined with the nature of the public bureaucracy (e.g. permanent tenure) add to this. However, because problems change, 'one generation's monuments may be the next generation's mausoleums' (Hogwood and Gunn, 1984:250). In times of economic growth we can afford the odd mausoleum or two, but this is less acceptable when there are fewer resources available.

A simple example is the institutional care of children. When social values were different young women who had children outside of marriage gave them up soon after birth. Institutions staffed with nurses and cooks and housed in expensive buildings were established to cope with this. However, as times have changed these institutions have become redundant. But they are not questioned. Staff remain and even new appointments are made. Similarly, institutions established to cope with the behavioural problems of children and teenagers become obsolete as the key profession in the area (i.e. social workers) redefines the treatment. Therapy is by counselling rather than disciplined control, and location should be in the community or family-based rather than in an institution. One institution run by the Queensland government was refurbished at a cost of \$500 000, had 13 staff (including a laundress, a cook and a gardener), but served few clients (it used to average only one to two children a week, sometimes none) because the relevant professional group regarded the existing staff as 'incompetent or resistant to change or continuing education', and consequently the institution was 'extremely cost ineffective' (this information comes from an internal departmental memo in the Queensland government). Getting that institution closed was a slow, expensive and debilitating process. This 'albatross' factor of public policy needs to be addressed. It is the fundamental impediment to making government and its bureaucracy more agile and less oriented towards accumulating more and more resources.

Another example is the establishment of the SBS-028 multicultural television network by the Fraser Government. Had SBS been established as part of the ABC in the first place, or had the ABC been made to change its operations to accommodate the new emphasis, as was suggested by some at the time,<sup>2</sup> then the recent fracas over the amalgamation of SBS and the ABC could have been avoided (see Schauble, 1986). The original separation of SBS from the ABC has allowed certain interest groups to better identify with this network and

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<sup>2</sup>A Senate Committee inquiry argued strongly against establishment of a separate network, but this was rejected by the Fraser Government. See Senate Standing Committee on Education and the Arts (1980).

this has probably been a factor in delaying the government's decision on the matter.

Furthermore, legislation is often too specific about administrative procedures and definition of policy issues. This 'Ten Commandments' approach in legislation enshrines a certain view of a policy problem developed at a particular time by certain professional groups. It also enshrines a certain way of dealing with the problem. Because the nature of issues changes, this precise legislation acts as a straitjacket on policy deliverers. Usually, major legislation that is so detailed is also hard to change. It is the focal point for professional group behaviour and public assessment of performance. Inevitably, either outdated methods remain, or those involved in the area conspire to develop elaborate strategies to do different things legally. It is a 'work practices' crisis of a different kind.

Consideration must also be given to that basic characteristic of the public sector — permanent tenure. This arrangement, combined with the complicated ritual of removing even the most blatantly incompetent staff member, also prevents policy change and the reallocation of resources. As a character in the David Williamson play, *The Department*, said, 'You have to be certified dead by three people before being sacked from here'. In 1984–85 only 51 officers were dismissed for disciplinary reasons from the Commonwealth public service out of a total staff of 169 000 (Public Service Board, 1985:129). The task here is to ensure that the public sector is not just stacked with political appointees, and to allow the existence of some counterweight to the vagaries of politicians.

More attention needs to be given to 'contracting out' certain functions to private or voluntary sectors to perform certain public functions. Public money is still used, but the role of the public sector is to set standards and supervise quality. Changes to policy might be more easily developed since usually the government is essentially dealing in one commodity — money — which can be more easily turned off or on. There are many examples of this happening in the welfare area. Child care, for instance, is essentially carried out by non-tenured staff. Certainly cuts will be resisted, but at least they are possible. Contracting can also mean employing people within the public sector for fixed terms. These 'hired guns' are given specific tasks and their continuation is dependent on factors like performance and demand. Tertiary education is now employing more staff on this basis. It gives institutions more flexibility, promotes competition, and, according to a recent report by the Tertiary Education Commission, has not harmed academic independence or competence.

More attention needs to be given to the actual means by which policies are to be achieved. For instance, should services be delivered directly to the consumer (whether by government organisation or

contracting staff) or should cash benefits be given? What is chosen will affect ease of policy change or termination. Delivery of services in kind (e.g. medical care) will mean professional staff, administrative support and thus more participants with interests in maintaining the policy. Also, the more specialised the staff involved, the less transferable they are to other areas of the public sector. In contrast, cash transfers can be administered by clerical staff easily moved to other similar areas. This process also gives more power to government to make unilateral changes or outright terminations. Witness the delays to pension increases or proposals to alleviate poverty traps announced in the 1986-87 Federal Budget.

It follows that we should ask 'not only what governments can promise, but what they can do' (Wildavsky, 1980:45). Governments can give people access to health services via programs like Medicare, but access is no guarantee to improved health. That is usually more dependent on personal behaviour. Governments should consider just what they are trying to do and select the appropriate tool (for a discussion of government outputs as 'tools' see Hood, 1983). This will not only save money, but will also make future alterations of policy easier.

One interesting development is the more effective use by government of its information and persuasive powers as an alternative to large bureaucracies delivering a direct range of services, or regulating certain types of activities. This has been called 'theatocracy', and it involves a range of symbolic gestures, warnings and persuasive arguments to alter certain behaviours that are socially undesirable (Lyman and Scott, 1975). The 'Life Be In It' campaign illustrates this approach. As its originator, Phillip Adams, suggested, governments should avail themselves of modern communication techniques like television to let the public know what government services are available and to change social attitudes (Adams, 1986). Naturally, this has manipulative overtones, but is it any different from providing incentives in the form of cash subsidies or tax concessions to alter people's behaviour? Moreover, it is relatively cheap, and modern polling techniques make it easy to evaluate, target or terminate (Mills, 1986).

Governments should resist all-embracing solutions to particular problems but should follow several different approaches to single issues. Robert Biller (1980:604-5) has summed up this approach in this way:

We may not have so much reached the limit of our resources, as we have rather reached the limit of our belief that resources applied in homogeneous ways to heterogeneous needs makes sense.

There is no one right way to do certain things. Today's policy solution unanimously agreed upon and then rigorously enforced inevitably becomes superseded as some other new panacea takes its place. In short, experimentation should be encouraged, diversity tolerated, and overcentralisation, a much-used strategy in times of cutbacks, avoided.

Making the bureaucracy more flexible is a necessary prerequisite to making policy change easier. In times of fiscal restraint there is a tendency for existing public sector rigidities to become more fixed. Thus, centralised coordinating agencies (e.g. the Public Service Board and Treasury) try to exert more control, departments resist by trying to retain existing programs, and politically weak policies are cut first. What public bureaucracy needs in these times is less centralised control and more positive leadership rather than penalties. All the existing deficiencies of public sector organisations are exacerbated in times of retrenchment. The result is that they are less able to cope, and the public gets even less value for money. Simplistic and politically easy strategies, such as across-the-board cuts or staff freezes, do not allow enough discretion by public sector managers to respond to changing circumstances. Cutbacks centrally imposed, short-term in origin and without taking into account the differences among the wide variety of public sector organisations, tend to make eunuchs of public sector managers whose virility was already questioned by their staff. Inevitably, productivity, already low according to critics of public organisations, plummets further as staff morale and opportunities (career and stimulating work) disappear.

Public sector organisations need to be made more aware of changes to their external environment (e.g. a new client group emerges) and to be able to adjust their outputs accordingly. This is the core of the problem. Outputs are too centrally fixed and resources too compartmentalised. One suggestion to overcome these problems is to give managers more incentive to respond to change. If demand falls, let departments retain some of the savings of winding down the old program. Some steps in this direction have been made recently, but they are too small to amount to any major change in direction (see Prime Minister R.J. Hawke's statement to parliament on Reform of the Australian Public Service, 1986). Allow staff who perform well to receive bonuses by ending the hierarchical, overdefined office position descriptions that too often mean attempting to fit people to job specifications (and salary levels) rather than making use of individuals' skills. Establish, as has been done in the USA, Canberra and Victoria, a special level of managers appointed on the basis of specific skills, who are rewarded for their ability to achieve defined objectives (like closing down an institution) rather than to maintain an existing program. Form staff into temporary project groups or task forces that can be quickly disbanded once set tasks have

been performed. These proposals, combined with allowing managers more responsibility, could enhance the ability of public sector organisations to respond to change. (For discussion of these issues in relation to the Victorian Public Service see Cullen, 1983.)

#### IV. CONCLUSION

This paper has emphasised the need to appreciate the political and administrative realities of our system of government in attempting to put small government into practice. Many other issues such as the devising of tactics to safely terminate policies could be mentioned, but space does not allow this. While total policy termination in some areas might appear to be a rational solution in times of economic decline, such an approach in our political system could be counterproductive. Public policy and our bureaucratic structures are the consequence of long-term developments, a wide variety of different goals, compromises, negotiations, and interest group pressures. Our public bureaucracies are not innocent disinterested bystanders, but have long been players in the policy process and have stakes in different policies as much as some of the clientele. Nor are public bureaucracies simple hierarchical structures with strong authoritative chains of command. Both within and between these organisations, public sector managers have to negotiate goals, boundaries and resources. We live in an imperfect world and no matter how righteous the cause may be these political and administrative realities have to be accepted. This is the point Robert Behn (1980:275) makes when he concludes:

The real challenge [of policy termination] is to accept government as it is — with its different goals, rules, pressures, incentives, and constituencies — and to attempt to deal with that reality ... Termination in government is — and always will be — a political process ... it takes politically intelligent managers to achieve it.

This is why political parties, however zealously they may embrace the small government gospel, are so reluctant to detail areas of expenditure cuts.

If the currency of politics is kudos, then one way politicians can be encouraged to promote policy change or terminate policies is to use less expensive goods like publicity and information based on the prestige and authority of government to gain support. New awards can be created, more advisory committees established and information campaigns launched (Rubin, 1980).

Another approach that has long been used by State governments in Australia is to either blame Canberra for the lack of funds, or use Canberra's money to claim credit. This is viable in Australia because so many federal programs ranging from road grants to welfare subsidies are administered by the States.<sup>3</sup>

However, this does not help our federal parliamentarians. Thus, more attention needs to be given to developing strategies to allow successful termination or policy change to occur (see Behn, 1978a). Just as policies are kept in place by interest groups, politicians must learn to develop new coalitions with those wanting termination. They must emphasise the opportunity costs of not terminating, and they must appreciate that in changing policy direction the price of minimising unrest might be short-term extra costs (e.g. redundancy payments) (Behn, 1978b). In short, the tough approach so stressed by advocates of cutbacks needs to be moderated so that cooperation rather than opposition can be developed. This is the role of the politician in our society.

Similar approaches need to be developed by public sector managers. Staff reductions by attrition rather than retrenchment might be more realistic and in the long term more effective. Care needs to be taken so that the public sector is not simply divided into winners and losers. Pain might have to be shared on occasion. It is up to the public sector manager to reinforce the positives of policy change or termination. For instance, he must be able to show that cuts in one area can be linked to enhancement of some other section. This can do a lot to mollify discontent (for more discussion of these issues, see Felsenthal, 1980; Greenhalgh and McKersie, 1980; and Cyert, 1978).

In conclusion, this paper has sought to stress how small government can be achieved in practice with a little patience and some appreciation of the operating norms of our policy-making process and government system. Attaining small government successfully with the minimal amount of trauma is like designing a car to reduce road deaths. The ultimate solution is either to design cars like tanks or to ban cars altogether. A less expensive and more practical solution would be to design cars with more emphasis on 'primary safety'. This would mean vehicles would have good brakes, improved visibility, direct steering, competent handling and a responsive engine and would therefore be better able to avoid accidents, take tight bends, and cope with slippery

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<sup>3</sup>This has long been a fault of our federal system. A recent example of a State government gaining all the kudos of federal funds occurred in the 1986 Queensland election, where the government's election policy speech included announcements of major road projects (Gatton and Nambour road bypasses) as State initiatives. In fact, these projects were totally funded by the federal government.

conditions. Making government more agile, like the car, is the way small government can be achieved in the long term.

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## COMMENTS

*James Cox*

In his paper Jon Craig looks at the role of explicit limitations on government expenditure, taxation and borrowing in controlling the expansion of public expenditure. As he points out, several OECD countries have imposed constraints on one or more of these variables. The Australian government is unusual in imposing limits on all three and I think Mr Craig approves of this. But, from some points of view, even the Trilogy commitments do not go far enough. A move to replace direct expenditures with tax expenditures with a related purpose would assist in meeting simultaneously two of the Trilogy commitments since both taxation and government expenditure would be reduced. This illustrates one of the great dangers of explicit controls on government expenditure and the like. They can be circumvented. Equally, however, it can be argued that the Trilogy commitments are too restrictive.

Others may be better qualified than I am to assess Mr Craig's review of overseas experience. The main lesson that I would draw is the importance of political will if expenditures are to be controlled. Mr Craig, for example, rather approves of the United Kingdom's Medium Term Financial Strategy, which requires governments to consider revenue prospects and consequences for several years into the future. Despite this Mr Craig feels that the British government is likely to indulge in a pre-election spending spree and, in any event, he sees its privatisation moves as being (among other things) an attempt to circumvent its self-imposed expenditure and deficit targets.

In the Australian section of his paper, Mr Craig gives the present Commonwealth government fairly high marks for its Trilogy of budgetary commitments. He would like to see the commitments further articulated into a medium-term financial strategy with particular attention being paid to increasing the amount of analytical information provided

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### *Restraining Leviathan*

through the forward estimates. But he wonders whether, in the event of a severe economic downturn, government would find it possible to live within the expenditure ceiling that it would like to impose on itself.

While I have some problems with Mr Craig's proposals, I agree with his judgments. The Trilogy commitments and the like can help to impose discipline on governments, but they are aids to political will, not substitutes for it. If governments and the communities they represent want smaller government, or want it to a sufficient extent to offset the pressures on governments to increase expenditures, then there is every reason to think they can get it. This is an issue that I return to below.

I read Mr Prasser's paper as being an appeal for the advocates of small government to take account of political and administrative realities. However desirable small or smaller government may be in principle, one has to think about how one is going to get there.

Among the realities that Mr Prasser rightly draws attention to is the difference between the public and private sector managerial environments. By contrast with the private sector, where the objective (profits) is fairly clear, government is very much concerned with trying to find an acceptable compromise between competing desirable objectives. Moreover, Mr Prasser argues, political competition necessarily gives an upward bias to government expenditures and the size of their attendant bureaucracies, while simultaneously making policy termination difficult.

Well, what are the solutions? There are some things that Mr Prasser would like us not to do — he thinks that across-the-board cuts or staff freezes do more harm than good. Mr Prasser would like to make government expenditure more flexible by making greater use of contract labour to replace day labour and by replacing direct government expenditure with (easier to vary) cash benefits. Behaviour could be modified at lower cost by using publicity campaigns rather than subsidies (although one might wonder about the effectiveness of such campaigns). Organisations themselves can become more flexible through the greater use of ad hoc task forces and pay related to performance. The termination of programs may be easier than otherwise if compensation (for example, redundancy pay) is paid to those who would be adversely affected.

Although Mr Prasser has a number of specific proposals I think that these are the main ones. It is no criticism of the author to say that these are proposals for marginal rather than fundamental change.

One should perhaps begin by questioning whether the community really wants smaller government. It seems to me (and to many other observers) that there is a degree of split-mindedness in our attitudes to taxation and government expenditure. We all favour reductions in taxation, and, in general, the reductions in government spending that

make them possible. But we are much less keen on reductions in those items of government spending that are of particular benefit to ourselves. This, of course, explains the notorious reluctance, to which Mr Prasser refers, of small government advocates to specify the areas in which they would like cuts to be made.

The more important point, perhaps, is that Australia's economic situation in the next few years will almost certainly call for continued fiscal restraint due to the very real balance of payments and external debt problems that Australia currently faces. Even those who would ideally like to see government doing more may accept that the next few years might not be the best time to introduce new programs. The rate of growth of expenditures that is consistent with macroeconomic balance is likely to be quite low. This is encapsulated in budgetary policy commitments such as the Trilogy. But expenditure on the existing programs of government is likely to grow faster than GDP for a number of reasons, including commitments to real growth (e.g. in defence or grants to the States), growth in the number of recipients (e.g. pensions and benefits) or increases in real interest rates (public debt interest).

This tendency to spending on the continuing programs of government to grow faster than permitted by the expenditure ceiling that is desirable on macroeconomic grounds is, in my view, the essence of the budgetary problems facing governments in Australia and similar countries. As successive editions of the Forward Estimates Reports of the Department of Finance illustrate, governments in all recent years have taken measures to reduce expenditure on their continuing programs. Depending on the priorities of the government these savings have been used either to reduce the fiscal deficit or to permit expansion of higher priority programs.

Perhaps I can now be forgiven for a brief sales talk. In November 1986 an EPAC Council Paper was released entitled 'Flexibility in Government Spending: Issues in Efficiency and Control' (Council Paper No. 23). This paper discusses the reasons why spending on the continuing programs of government grows faster than seems desirable on macroeconomic grounds and suggests measures that may enhance the degree of flexibility in government spending.

Unless governments can exercise control over spending programs and generate flexibility by reviewing past policy decisions, they will not be able to address changing social needs while ensuring that budget policy is consistent with sound macroeconomic management. At the same time, recipients of government expenditure require a stable environment in which to plan for the future. Fiscal flexibility and stability of spending programs are competing objectives of government. The tensions between these objectives can be minimised through medium-term budgetary and expenditure planning, but conflicts will inevitably occur. Macroeconomic considerations will generally need to

prevail in such circumstances, requiring a degree of flexibility in adjusting expenditures.

Factors limiting flexibility in government spending include:

- contractual obligations such as public debt interest and wages and wage-related payments;
- indexation provisions (some two-thirds of Commonwealth outlays were indexed formally or informally in 1985-86 and the proportion has been increasing);
- the proportion of expenditure subject to standing rather than annual appropriations;
- commitments in legislation to future expenditure, for example (at the Commonwealth level) education payments and payments to State and local governments;
- the open-ended nature of many transfer programs; for example, the Commonwealth is required to pay pensions and benefits to all who qualify.

Government expenditure has become less flexible at the margin as the composition of spending has shifted from capital items to less easily controlled expenditure such as personal benefits and public debt interest.

So much for the diagnosis of the problem. What about the remedy? Like Mr Craig I consider that political will is the main ingredient. For example the Hawke Government showed in its first year in office a willingness to make quite significant changes in the composition of its expenditures. Like Mr Prasser I have a number of marginal changes to suggest. There are seven of them.

First, looking beyond the Trilogy, the further development of a medium-term approach to fiscal policy, with maintenance of firm, explicit limits on the growth of overall expenditure and public sector borrowing.

Second, the review of tax expenditures in the same context as direct expenditures.

Third, emphasis on decentralisation of control over detailed spending decisions to ministers and departments within firm portfolio expenditure limits. This should facilitate the reordering of spending priorities within portfolios as circumstances change.

Fourth, extensive use of efficiency and effectiveness reviews to determine whether individual programs are the best way of meeting the government's objectives. A good deal of attention has recently been paid at Commonwealth and State government levels to efficiency reviews — whether there is waste in the delivery of government services that can be cut out. For example the Prime Minister has recently announced the establishment of an Efficiency Scrutiny Unit. Far less attention has been paid to the more difficult — but I believe more important —

question of effectiveness reviews: whether existing government programs are the best way of doing things. This question is difficult because it inevitably gives rise to issues of bureaucratic and ministerial rivalries.

Fifth, a strengthening of parliamentary review processes.

Sixth, increased use of user charges.

Seventh, greater attention to providing public information to promote a better climate for policy change and to enhance community awareness of the costs as well as the benefits of government expenditure programs.

## DISCUSSION

**Patrick Minford (University of Liverpool):** As someone involved in the formulation of the Medium Term Financial Strategy in the UK, it seems to me that we need to avoid confusing the micro controls over public spending with the macro controls used in monetary policy. If they are confused, we may fail to achieve both objectives. In 1981, in order to meet British monetary macro targets, taxes had to be substantially raised. Had we confused that with the effort to control public spending we would have had the problems the Americans are now experiencing with their budget deficits. The MTFS succeeded as a monetary weapon, but certainly not as a control over public spending. The two need to be kept separate.

**Jon Craig:** I think the British did achieve a degree of expenditure restraint, though not as much as one would have liked. True, the MTFS was concerned with monetary growth and the Public Sector Borrowing Requirement, and was not instituted specifically to control public spending. But it provided a good framework and was an improvement on the earlier years, when expenditure was linked to GDP alone, without reference to deficits and revenue.

**Robert Miller (Regulation Review Unit, Melbourne):** What do the speakers think about sunrise or sunset legislation? There have been proposals in Queensland and Victoria to automatically repeal or rescind all regulations brought in before 1962, and to impose a ten-year life cycle on all post-1962 regulations. California imposes a limited life-span on many of its laws and regulations, and now requires that the quantity of legislation must be reduced each year.

**Scott Prasser:** Reviews of sunset legislation are often carried out by the organisations affected by the legislation, which can be self-defeating. Some of the evidence from the US suggests that the use of sunset legislation has not been particularly successful in containing the political pressures for the continuation of programs.

**Cliff Walsh (University of Adelaide):** It seems to me that political will is a necessary but by no means sufficient condition for containing big government. There has to be some kind of sanction to back up rules imposing limits on total expenditure. The issue is not so much 'flexibility' and 'agility' in spending programs; rather it is one of persuading middle-class voters to accept the spending cuts that need to be made before taxes can be cut. This can be done only by sharing around

the pain: agreeing not only that we all prefer a smaller public sector but also that we are each prepared to forgo some benefits because everyone else is willing to do the same. The best long-run constraint on expenditure (other than the constitutional variety) is likely to lie in the tax power. The devices of the flat tax and tax indexation would force governments that wanted to increase expenditure to confront the painful option of lifting the tax rate.

**Craig:** The Gramm-Rudman law has certainly not caused much pain yet in the US. In Australia, the strongest sanction is coming from the difficulties involved in financing the budget deficit. This will soon force the Australian people to vote directly on the question of whether they want to pay for more public spending through higher taxation.

**Edwin Brooks (Riverina-Murray Institute of Higher Education):** One problem with long-term fiscal plans in Australia is that they are unlikely to survive the number and frequency of our elections. For a long time we have had a federal election every two years on average.

The incremental approach that has so far been dominating the discussion is not really likely to work. Surely it's impossible in the real world to share equally the pain of spending cuts. One must build a coalition of interests that believe they have something to gain from electing one party rather than another, even if this means that others lose.

**Prasser:** I agree. Too many of the operational norms in the public sector assume that everyone either shares the pleasure or shares the pain, when in reality that's not possible. But if we are going to cut back, we need some skilful political footwork to make sure that the losers are not the politically weak — those who most need assistance.

**The Death of Constitutional Law  
— 'Paper Tigers' and Utilitarian  
Government**

*Robin O'Hair*

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# The Death of Constitutional Law — 'Paper Tigers' and Utilitarian Government

*Robin O'Hair*

## I. AUSTRALIA AND UTILITARIANISM

The existing constitutional limitations on government in Australia are enfeebled and not far from being gutted. This has not been achieved in a day or a week, but is the result of a process that resumed in the early 1970s and shows no sign of abating.

The key to understanding that process, albeit its major constitutional case law manifestations will be referred to in the course of this essay, is the loss of a moral dimension to legal obligation. This has always been very frail in the legal profession in this country, despite the teachings of the great common lawyers, because Australia has a utilitarian culture. Accordingly, legal positivism, and latterly legal realism, are strong in this country.

Edmund Burke's description of the problems of a polity devoid of a moral foundation are readily perceived in the words of Alexander M. Bickel, the great American constitutional theorist, as follows:

In order to survive, be coherent and stable, and answer men's wants, a civil society had to rest on a foundation of moral values. Else it degenerated — if an oligarchy, into interest government, a government of jobbers enriching themselves and their friends, and ended in revolution; or if a full democracy, into a mindless, shameless thing, freely oppressing various minorities and ruining itself. (Bickel, 1975:23)

The reason politics must be cabined by principle is that it is about accommodation and compromise respecting interests that collide. If there is no basis to limit the sphere of politics, then the computing principle associated with accommodation and compromise will be

identified with utilitarianism. Instead of rights tending to support the legitimacy of competing claims being found *dehors* politics, thus leading to their peaceful accommodation by politics, the legitimacy of claims will be identified with the outcome of the political process itself. Politics ceases to be the means by which existing claims that collide may be reconciled and becomes the means by which novel claims may be made. This will guarantee the politicisation of society. The results of such a politicisation are not likely to be congenial to anyone, save the few who administer it, yet the capacity to break politicisation once it exists is small, as fear of political retaliation deters.

The reason utilitarianism is the philosophy that supports the destruction of any moral limits to politics may be traced to Dr. Bernard Mandeville. It will be recalled that his book, *The Fable of the Bees*, contended that private vices conduced to public benefit. Mandeville saw outwardly moral behaviour profaned by immoral and unworthy intentions, yet the results of such behaviour redounded to the benefit of all.

This insight led to two schools of thought. The first and most intellectual has on occasion been misleadingly called 'anti-rationalism' and today is called 'evolutionary rationalism'. This school, which is composed of greats such as David Hume, Adam Smith, Adam Ferguson, Sir Karl Popper and F.A. Hayek, saw that Mandeville's genius had illuminated the problem of the unintended consequences of human action. Such insight ultimately led to what Nozick (1974:18 ff.) has described as 'invisible hand explanations'. This school, while Whig and not Tory, is adequately skeptical about socioeconomic reconstruction, because of the influence and effects of unintended consequences within the structure of culturally evolved institutions. In a sense its views are utilitarian, but not in the sense in which the word is used in the present discussion. John Gray has put the matter well in relation to F.A. Hayek, the school's leading modern proponent:

The utilitarian component of Hayek's conception of morality is indirect in that it is never supposed by him that we ought or could invoke a utilitarian principle to settle practical questions: for, given the great partiality and fallibility of our understanding, we are in general better advised to follow the code of behaviour accepted in our own society. That code can, in turn, Hayek believes, never properly be the subject of a rationalist reconstruction in Benthamite fashion, but only reformed piecemeal and slowly ... [T]he proper role of utility is not prescriptive or practical but rather that of a standard of evaluation for the assessment of whole systems of rules or practices.

[T]he test of any system of rules is whether it maximizes an anonymous individual's chance of achieving his unknown purposes. (Gray, 1984:59, 60)

It follows that evolutionary rationalists reject Benthamite utilitarianism as additive, collective and authoritarian, for it seeks to concentrate all decision making in one all-knowing 'social mind', with the choices of individuals being votes that may be overruled in the 'social mind' by other more numerous votes. On the other hand, evolutionary rationalists, like the classical common lawyers, seek to minimise collisions between individuals so that as many individual ends may be as peaceably pursued as possible in society with individuals, not the 'social mind', choosing for themselves. This explains Milton Friedman's statement:

The characteristic feature of action through political channels is that it tends to require or enforce substantial conformity. The great advantage of the market, on the other hand, is that it permits wide diversity. It is, in political terms, a system of proportional representation. Each man can vote, as it were, for the color of tie he wants and get it; he does not have to see what color the majority wants and then, if he is in the minority, submit. (Friedman, 1962:15)

The other school — the utilitarians or naive rationalists — read Mandeville very simplistically. Their approach was and is to regard Mandeville as showing there is no intrinsic vice or virtue in society, and hence all behaviour has to be judged by its results (Hayek, 1978:264; Goldsmith, 1985:144, 158). This school has little time for, and less understanding of, the problems in determining what are the results. It is a doctrine predicated on an unattainable perfect foresight, but sold on public interest grounds. To operate politically, it requires a preliminary showing of generalised immediate benefits and the exploitation of anti-intellectualism and apathy, to ensure that the facile showing of such benefits is impregnable from attack. Any attack upon such a showing is swiftly derided as the carpings of a few who are injured by the achievement of a greater good. These people are perceived as having no rights, as rights are conceived as a product of the political process and therefore to have lost politically is to be devoid of rights.

When Australia is perceived as a utilitarian culture, then certain approaches and conceptions cease to carry weight. One of these is the rule of law, another is the concept of constitutional limitations. No Australian prime minister since Sir Robert Menzies has had any clear attachment to these principles. We seem remote from an age when Sir Robert's dear friend, Sir Owen Dixon, was able to say:

[The Constitution] is an instrument framed in accordance with many traditional conceptions, to some of which it gives effect, as, for example, in separating the judicial power from other functions of government, others of which are simply assumed. Among these I think that it may fairly be said that the rule of law forms an assumption. (*Australian Communist Party v Commonwealth* (1950-1951) 83 CLR 1, 193)

Equally distant seems the argument of Dr H.V. Evatt KC, the then federal leader of the Australian Labor Party and a former justice of the High Court, on behalf of the communists, that:

Under the Constitution, Acts of Attainder and Bills of Pains and Penalties are impliedly prohibited in the case of the Commonwealth because they would represent an exercise of judicial power by the Parliament. (p.74)

## II. THE END OF THE SEPARATION OF POWERS AND FEDERALISM

Those sentiments of Sir Owen Dixon and Dr H.V. Evatt do not sit well with the course of decision in the High Court of Australia in recent times. In *Hilton v Wells* (1985) 58 ALR 245, a majority supported the proposition that it was not inconsistent with the separation of judicial from legislative and executive power for the parliament to impose unilaterally, non-judicial functions on federal judges, even though it would be unlawful to confer non-judicial functions on federal courts, for the judge is selected as a *persona designata* and not as a judge of a court.

To this proposition, the dissentients answered:

In the present case, the function of issuing warrants is conferred upon all the judges of the Federal Court indiscriminately. It is exercisable by a judge of that court in circumstances in which he is not appointed to a separately constituted tribunal. If the function is exercisable by him otherwise than in his character as a judge it must be because he is intended to discharge the function personally, detached from his judicial office as a member of the Federal Court. In saying this we reject the notion that functions may be entrusted to a person as a judge, but not as a member of the court to which he belongs. The metaphysical notion of a judge acting in his character as a judge, at large, so to speak, detached from the

court of which he is a member, cannot be supported as a matter of legal theory.

... One may ask: What is the point of our insisting ... that non-judicial functions shall not be given to a ... court, if it is legitimate for Parliament to adopt the expedient of entrusting these functions to judges personally in lieu of pursuing the proscribed alternative of giving the functions to the court to which the judges belong. (*Hilton v Wells* (1985) 58 ALR 245, 261)

The court has also unanimously rejected the challenge of the Builders Labourers' Federation to its deregistration by legislative act (*Re Ludeke; Ex parte Australian Building Construction Employees' and Builders Labourers' Federation* (1985) 62 ALR 407). While the court would seem to be on reasonably firm ground in regarding the power of deregistration in the form existing under legislation at the time of registration of the union as authorising deregistration as an executive or legislative act, a grant of incorporation is nevertheless generally regarded as a proprietary right, or at least as involving a right of a contractual character. Accordingly, one may be permitted to wonder whether a statute for the express purpose of deregistering a particular association and depriving it of corporate status does not transgress a vested right that did not exist in previous union deregistration cases, as the power preceded the registration of the union. If that is the case, then a genuine judicial power issue would appear to arise, as a statute in the form of a bill of attainder would appear to be opposed to the separation of judicial power from legislative power, as the Privy Council has held (*Llanage v The Queen* [1967] 1 AC 259).

The separation of legislative and executive power from judicial power has not in recent years fared well in the High Court. The above are merely illustrative of a trend. No doubt a utilitarian calculation would support the tapping of telephones on the warrant of a federal court judge, as in *Hilton v Wells*, and the banning of the BLF, but the basic commitment involved in the rule of law, and accordingly in constitutional guarantees, is that government should forswear certain means to achieve its ends. This is simply because people have rights, which it is not proper for government to forfeit without just cause.

The whole structure of federalism has itself been destabilised, not merely the separation of powers. The decisions of the High Court in the *Tasmanian Dams Case* (1983) 46 ALR 625, *Murphyores Incorporated v Commonwealth* (1975-1976) 9 ALR 199, and *Fencott v Muller* (1982-1983) 46 ALR 41, ensure that there is no area of private endeavour in Australia not within the reach of federal power, if powers are ingeniously used. The federal monopoly of income tax collection, which is a practical but not legal monopoly, when coupled with the

conditional grants power and practical federal control of the Loans Council, ensures there is no area of public activity not within federal power to affect.

The separation of powers and the division of powers, both of which appear in the constitution, have been rendered 'dead letters'. They have died because the judiciary has failed to enforce them, but more importantly they have died through lack of public support for rights-based arguments when confronted with arguments of utility.

Alexander Hamilton, in *Federalist No. 84*, indicated that the careful separation and division of powers led to the conclusion 'that the Constitution is itself, in every rational sense, and to every useful purpose, A BILL OF RIGHTS' (Lodge, 1888:538). That effect was achieved by ensuring that the separation of powers stopped the deprivation of rights without the application by judges of general rules, which rules had already been applied by the executive, whose decision was challenged before the court. The general rules were, of course, the product of a bicameral parliament. The division of powers between federal and State parliaments made any attempt at utilitarian planning of society an impossibility. This is because it divided power over topics and provided means for private parties to escape the rigour of uniform national controls. The existence of legal substitutes to the areas under federal or State control meant that opposition of federal or State governments to private endeavour could be, and was, circumvented.

Before the immense expansion of the corporations power, internal commerce was principally left to State regulation, but foreign commerce was under federal regulation. In *O'Sullivan v Noarlunga Meat Ltd* (1954) 92 CLR 565, a federal export licence preserved an abattoir from a State statute vesting a monopoly in a State instrumentality. Equally, the High Court's decision in *R. v Barger* (1908) 6 CLR 41 postponed the imposition of uniform wages in most industries across Australia for almost 30 years, thereby allowing for competitive wages in non-unionised industry. Perhaps more importantly, the decisions in *Huddart Parker & Co. Pty Ltd v Moorehead* (1909) 8 CLR 330, *New South Wales v Commonwealth* (1915) 20 CLR 54, and *R. v Burgess; Ex parte Henry* (1936) 55 CLR 608, postponed uniform, peacetime federal economic regulation till over 70 years after federation.

It is appropriate to ask what has caused the lack of public support for this Bill of Rights. The principal reason has been the rise of naive rationalism, or utilitarianism. It has not been the rise of socialism, for the advocacy of the dismantling of this Bill of Rights has not been confined to socialists (see, for instance, the remarks of Sir John Latham, 1952:ix-x, who was, some time prior to his appointment as Chief Justice of Australia, the head of the Non-Labor Federal Opposition).

Professor Geoffrey Sawer, himself a member of the Australian Labor Party, has described this attitude in the present context, thus:

For men of generous aims, vigorous temperament and leadership quality, it is discouraging to start off accepting the federal handicaps ... Nation-builders and political leaders like to be able to promise the people that only the inevitable imperfections of human wisdom and character stand between them and Utopia, and their leaders will set them marching in that direction with all deliberate speed. But if the constitutional system is federal, an honest leader has to warn his people that the weaknesses of human nature will inevitably be magnified in effect by the inherent properties of the governmental structure. Believers in non-government are the only people likely to be positively attracted by the qualities of federalism ... (Sawer, 1969:182-3)

The strength of federalism has accordingly been progressively weakened in a country as statist as Australia, as the public have come to see themselves as Australians and not New South Welshmen or Queenslanders or whatever. Once the old prejudices die, the attractions of a government emphasising local power are minimal in Australian political culture. Local government is weak in Australia. Schooling and police are highly centralised in the States, to pick but two examples. Even town planning is centralised in some States. With local government weak and classical liberal attitudes scarce, the centripetal tendencies of Australian law are unsurprising.

To devotees of naive rationalism, and to its opponents who are sufficiently illiterate to believe the goals of naive rationalism are achievable, there is something deficient in a governmental structure that allows choice to individuals, instead of permitting a few men in government to conceive of a 'perfect vision', and then have 'adequate' power to implement it. While Hayek has shown naive rationalism to be superstitious, in that a superstition pretends to account for more than is known, as naive rationalism assumes knowledge and agreement upon ends that do not exist, this has not limited its attraction.

The destruction of the separation of powers is accounted for by similar reasoning. Separation is felt to reduce the capacity to plan 'scientifically' (cf. Landis, 1940:1094; and Pillsbury, 1922-1923:405-7). Separation is also thought to be without meaning, because positivist and realist theories of adjudication equate judges with legislators. Once the concept of courts declaring pre-existing social practice and convention to be law is lost, the legislative conception of judicial function becomes irresistible. This is a bridge that the High Court has crossed.

### III. INEFFECTIVE GUARANTEES

There are a catena of outright constitutional guarantees in the Constitution, however most of them are also 'dead letters'. Section 116 is meant to stop the establishment of any State religion, yet it is inadequate to stop deep federal penetration into the parochial school system (*Attorney-General (Vic.) (Ex rel. Black) v Commonwealth* (1980-1981) 33 ALR 321) and federal judges determining what religious upbringing is better for a child when his parents divorce. (Even as restrained an approach as that evidenced in *In the Marriage of Pasio* (1978) 26 ALR 132 has since been disavowed by the High Court on the occasion of special leave to appeal being refused. See *New v New* (1982) *The Legal Reporter* 3(4):7.)

Section 99 is intended to stop the Commonwealth from conferring trade or commercial advantages on one State or part thereof over another State, yet it has been severely confined. It has been read to apply only to legislation of a kind that could be enacted on the topic of interstate or foreign commerce (*Morgan v Commonwealth* (1947) 74 CLR 421); hence other powers, such as the trading corporations power, may do the discriminating.

Further, it has been dogged by a metaphysical distinction that asserts there is some difference between Sydney as a part of New South Wales, and Sydney as a locality. This distinction without a difference is said to allow preferences for localities, but not parts of States. Sir Owen Dixon trenchantly attacked this doctrine as meaningless (*Commissioner of Taxation v Clyne* (1957-1958) 100 CLR 246, 266).

Section 100 is to protect the use of water from rivers from federal interference. It has been read to apply only to the interstate and foreign trade and commerce power, so, for example, this section had no bearing when the Franklin Dam was blocked under the power over trading corporations (*Commonwealth v Tasmania* (1983) 46 ALR 625).

Section 117, which prohibits discrimination by a State against residents of other States, has been held ineffectual to strike down residency requirements for professions, because, according to a majority of the High Court, one can satisfy a residency requirement by living in the State imposing it, while still remaining a resident of one's home State who merely happens to be absent (*Henry v Boehm* (1973) 1 ALR 181).

Section 41, which appears to guarantee people a vote federally, if they have a vote for the more numerous house of a State, has been held to apply only to those people who were alive in 1901 (*Re Pearson; Ex parte Sipka* (1983) 45 ALR 1).

Section 80, which appears to guarantee a right to trial by jury for federal offences, has been read so that it is the parliament's choice

whether there is a jury or not (*R. v Archdall; Ex parte Carrigan* (1928) 41 CLR 128).

The only provisions of the constitution in the nature of constitutional guarantees that have any efficacy are sections 51(xxiiiA), 51(xxxi), 90 and 92.

#### IV. THE FUTURE OF THE FREEDOM OF INTERSTATE COMMERCE

Section 92 guarantees the freedom of commerce and movement between the States. Murphy J waged an unremitting battle to have it read out of the constitution (this commenced in *Buck v Bavone* (1975-1976) 9 ALR 481, 498 ff.). It would, in any case, have been singularly distorted so as not to apply to the federal government if the Privy Council had not overruled the High Court of Australia (*James v Commonwealth* (1936) 55 CLR 1). Sir Zelman Cowen, Sir Isaac Isaacs's sympathetic biographer, has indicated that Isaacs J went too far in attempting this (Cowen, 1967:189).

Recent trends in section 92 law point to the view it will not see out the decade as an effective check on government power. Stephen and Mason JJ in *Uebergang v Australian Wheat Board* (1980) 32 ALR 1 have said in relation to section 92:

The evidence which we would regard as relevant in determining the validity of the present legislation would be such material as would enable the court to determine whether or not the restrictions which the legislation imposes upon interstate trade are no greater than are reasonably necessary in all the circumstances. For example, it would be relevant to establish what are the goals sought to be attained by the restrictions; how these may be weighed against those restrictions and whether they can be attained by other means which do not involve such onerous restraints upon traders. (p.28)

What is implicit in the above quotation is that freedom of interstate commerce, a constitutionally guaranteed right, must be part of a utilitarian calculus that weighs it against the goals sought to be achieved by government. Those goals will be permitted, no matter how hard they bear down on the constitutional right, provided the means adopted to achieve them go no further than is necessary to do so. It should be noted that the case involved the question of whether a statutory monopoly could be imposed on the wheat trade — the very antithesis of freedom of commerce.

By parity of reasoning, in a country with a constitutional guarantee that prohibited the death penalty, the government could still execute people provided it could show this was the only means compatible with its goal of ending recidivism, protecting the public, deterring criminality and doing so cheaply, provided it could show the condemned person was executed in a way no more painful than was absolutely necessary to kill him. With all due respect, it is a nonsense.

The problem of the joint judgment is that it treats a matter that should be dealt with as a plea of confession and avoidance, as if it founded a demurrer to the plaintiff's statement of claim; accordingly the judgment fails to admit there has been a violation of the plaintiff's constitutional right, and thereby avoids the question of what may justify it. The problem for the joint judgment, of course, is that there is no known basis to justify such an invasion.

The conventional approach to the problem of what legislation is compatible with freedom of interstate commerce was:

- To ascertain the extent of freedom of commerce at common law (one has a common law right to trade: cf. Lord Reid in *Bellshill & Mossend Co-operative Society Ltd v Dalziel Co-operative Society Ltd* [1960] 1 All ER 673, 676), for example, fraud is not part of that freedom at common law.
- To permit statutes that pursued a goal accepted at common law, for example, the suppression of fraud, provided they adopted means no more burdensome on legitimate commerce that necessary. (E.g. *Collier Garland Ltd v Hotchkiss* (1957) 97 CLR 475, where a requirement to register a motor vehicle was struck down as the process of obtaining registration was unduly onerous (p.487). The system of registration permits, inter alia, the attribution of responsibility to those who commit torts. This is perfectly congruent with common law, as a goal.)
- To prohibit statutes whose goals were opposed to the very idea of freedom of commerce at common law, for example, statutes promoting government monopolies (e.g., *Hughes & Vale Pty Ltd v NSW [No.1]* (1954) 93 CLR 1, 26-8).

There seems little doubt that the approach of Stephen and Mason JJ will triumph on the High Court. Section 92 will thereafter be a dead letter. (Sir Garfield Barwick CJ's powerful judgment in *Uebergang v Australian Wheat Board* (1980) 32 ALR 1, 16-17 makes this point.)

## V. THE EXPANSION OF TAXATION

Section 90 prohibits the States from levying duties of customs and duties of excise. This has led to the low level of indirect taxation in Australia, and also to a lower level of taxation. It has also stopped certain States exploiting high federal tariff walls to tax at high rates goods produced in the State but sold interstate. Politicians like taxing those who do not vote for them.

Sir Owen Dixon, in the course of a masterly judgment on the meaning of the word 'excise', said:

If the word 'excise' received a meaning which confined its application to taxes the relation of which to the commodity concerned was of some narrow and strictly defined nature ..., it would not only miss the principle contained in the use of the word 'excise', but it would expose the constitutional provision made by sec. 90 to evasion by easy subterfuges and the adoption of unreal distinctions. (*Matthews v Chicory Marketing Board* (1938) 60 CLR 263, 304)

Notwithstanding this admonition, the High Court has held that while it is an excise, and accordingly unlawful, for a State to tax a retailer by requiring him to take a licence and pay a tax equal to a percentage of his sales, nevertheless it will not be an excise if the State does not tax him the first year he conducts business, but does thereafter tax him on a percentage of his sales in the previous year as the price of renewing his licence. The reason for this decision is said to rest on the possibility that he may decide against renewing his licence and so may not pay the tax, hence it need not necessarily be passed on to consumers. It is noteworthy that this 'principle' was first applied in a case where the likelihood of a failure to renew a licence was infinitesimal — retail liquor licences (*Dennis Hotels Pty Ltd v Victoria* (1960) 104 CLR 529). They have a monopoly rent value.

This has led to 'easy subterfuge' by virtue of this 'unreal distinction'. Nevertheless, the High Court, while repudiating the reasoning, persists with the holding of the case on the basis that State budgets should not be disrupted (*Evida Nominees Pty Ltd v State of Victoria* (1984) 52 ALR 401). Such tender indulgences are not conceded to private litigants, who may see their financial positions severely eroded by novel judicial decisions overruling a catena of authorities (*Hackshaw v Shaw* (1984) 56 ALR 417; reference may be made to the dissent of Sir Daryl Dawson, pp.466-7, to appreciate the scope of the holding).

## VI. THE DESTRUCTION OF PROPERTY

So far as section 51(xxxi) is concerned — the acquisition power — it requires that property not be compulsorily acquired on other than just terms by the Commonwealth or by any person acting under a right granted by a federal enactment.

Until recent times, this had been the constitutional protection most liberally construed and applied. In the *Tasmanian Dams Case* its strength was severely shaken. Three of the four judges who formed the majority on the other issues in the case (Mason J, pp.707-9; Murphy J, p.738; and Brennan J, pp.795-6) took the view that if the Commonwealth determines to prohibit the use or development of an area in order that it remain an open space, then it has not acquired property and so no compensation is owed. It has merely destroyed property. Those justices said the American cases on 'takings' were not relevant, as they extended beyond acquisition.

It is noteworthy that Lord Radcliffe, in construing a constitutional prohibition on 'takings' in the Government of Ireland Act 1920, said:

I do not see how you can give a meaning to this phrase, 'taking without compensation', except by reference to the general treatment of the subject in the law of England and Ireland before 1920 ... Acquisition of title or possession was 'taking'.

What is important, I think, is to recognize that, though interference with rights of development and user had come to be a recognised element of the regulation and planning of towns in the interest of public health and amenity, the consequent control, impairment or diminution of those rights was not treated as a 'taking' of property ...

I do not imply by what I have said that I regard it as out of the question that, on a particular occasion, there might not be a restriction of user so extreme that in substance, though not in form, it amounted to a 'taking' of the land affected for the benefit of the public. It is not easy to imagine such a restriction being imposed by a responsible authority ..., the more so as the Act deals separately with open spaces as a subject of acquisition not without compensation. (*Belfast Corporation v O.D. Cars Ltd* [1960] 1 All ER 65, 72,73,74; emphasis added)

If one accepts the approach of Mason, Murphy and Brennan JJ, then a logical extension would be that the Commonwealth may withdraw the banking licences to conduct intrastate banking of Westpac, ANZ, and National Commercial, along with every other licensed private bank, and

there will be no acquisition by the Commonwealth Bank of their businesses, even of their goodwill. This would appear to conflict with *Ulster Transport Authority v James Brown & Sons Ltd* [1953] NILR 79.

If the approach of Mason, Murphy and Brennan JJ were accepted, then *Minister of State for the Army v Dalziel* (1944) 68 CLR 261 would be severely limited in its application. Sir Owen Dixon described the effect of that case thus:

I take [that case] to mean that s.51(xxxi.) is not to be confined pedantically to the taking of title by the Commonwealth to some specific estate or interest in land recognised at law or in equity and to some specific form of property in a chattel or chose in action similarly recognized but that it extends to innominate and anomalous interests ...

Section 51(xxxi.) serves a double purpose. It provides the Commonwealth Parliament with a legislative power of acquiring property: at the same time as a condition upon the exercise of the power it provides the individual or the State affected with a protection against governmental interferences with his proprietary rights without just recompense. In both aspects consistency with the principles upon which constitutional provisions are interpreted and applied demands that the paragraph should be given as full and flexible an operation as will cover the objects it was designed to effect. (*Bank Nationalization Case* (1948) 76 CLR 1, 349)

The Constitution will be mocked if *Dalziel* is to be narrowly confined.

It is a niggardly conception of human endeavour to link everything to exchange and to economics. The fact that the Commonwealth may acquire very little in the nature of money or money's worth with the acquisition of an anomalous interest in land in Tasmania proves nothing. Aesthetic considerations are quite sufficient to motivate the purchase of an interest denying the opportunity for development. Such pleasure as is derived therefrom may not count in money or money's worth, but that is beside the point, as the 'Save the Redwoods' Society would no doubt attest. To insist that the Commonwealth purchase an interest 'worth owning', from the point of view of resale, is nothing short of absurd.

## VII. THE DECLINE OF MEDICAL PRACTICE

The remaining explicit constitutional guarantee to be mentioned is that found in section 51(xxiiiA) of the Constitution. It permits the federal provision of medical and dental services, provided that no 'form of civil conscription' is imposed.

In *Federal Council of the British Medical Association in Australia v Commonwealth* (1949) 79 CLR 201, a very liberal view of this prohibition was taken. Sir William Webb said:

When Parliament comes between patient and doctor and makes the lawful continuance of their relationship as such depend upon a condition, enforceable by fine, that the doctor shall render the patient a special service, unless the service is waived by the patient, it creates a situation that amounts to a form of civil conscription. This civil conscription can be avoided, without any breach of the law, to the extent that the doctor vacates the field of medicine, which, however, would involve, in many if not most cases, a considerable loss of practice and of income. But it is still civil conscription. Military conscription would not cease to be such because those liable to it might avoid it by a change of occupation. (pp.194-5)

In 1980, a majority of the High Court repudiated the above approach and held 'civil conscription' not to exist where the compulsion related to the structure of the service the doctor had agreed to provide and did not obligate the provision of such service (*General Practitioners' Society in Australia v Commonwealth* (1980) 31 ALR 369, 388-9). In other words, the doctor/patient relationship could be restructured so long as entry into that relationship remained voluntary. Freedom of medical practice ceased to be protected.

### VIII. THE SENATE

The structure of the Australian Senate has had a profound effect on Australian politics. Unlike the Canadian Senate, the Australian Senate is elective and has equality of representation from the States (the Canadian Senate does have regional representation, but it is appointive and hence does not guarantee senators in tune with regional interests). Unlike the United States, the necessity to form a government from the floor of the House of Representatives ensures that there must be cohesion in party politics.

The effect the Senate has had in Australia is to minimise regional politics. Its structure has operated as a States' House, by rendering the conduct of regional politics an unsuccessful strategy, for heavy regional backing may guarantee control of the House of Representatives but not of the Senate. 'Beggars thy neighbour' regional politics at the federal level have been largely banished by the Senate's structure. This has meant that politics tends to be ideological, as it does not pay a politician

bent on government at the federal level to promote regional disunity on a massive scale.

While Tasmania has become something of a regional prize in recent federal elections, this is merely a 'side-show'. It is not possible to sustain a federal government by avowed opposition to all things Tasmanian. Nevertheless, such an approach may prove successful on a State or local political basis.

Unfortunately, even this guarantee of the absence of regional distempers has been severely undermined, over trenchant dissents. The High Court has now twice affirmed that the Senate may be increased in size by the addition of senators from federal territories who need not be elected but may be appointed by the government of the day (*Queensland v Commonwealth* (1977) 16 ALR 487 and *Western Australia v Commonwealth* (1975) 7 ALR 159). This could be used to severely undermine the disincentive to regional politics.

## IX. THE CAUSES OF INSTITUTIONAL FAILURE

It would be tempting, but nevertheless erroneous, to conclude that the trend of this jurisprudence — its hostility to constitutional limitations and guarantees — was a product of some sort of conspiracy or that the bench was somehow radical, and that this trend could be reversed by appropriate appointments. This would be very unfair to the Court and its members. Indeed, five of the present seven justices received their present judicial commissions while the Hon. Senator P. Durack was federal Attorney-General, in the successive Fraser Ministries.

The High Court, unlike the Supreme Court of the United States, still basically remains a reactive institution. While its collective outlook seems to be strongly opposed to the enforcement and liberal application of constitutional restraints on government, it nevertheless is merely refusing to counter substantive governmental choices made within a system that is heavily democratic, albeit not exclusively so. Although that refusal does seem substantially flawed and inclined to enshrining legal absolutism, particularly since the court will not even protect the electoral franchise itself, nor the representative structure of governmental institutions, it represents authentic aspects of Australian culture that are substantially opposed to liberal constitutionalism.

Sir Victor Windeyer, who is generally regarded as 'a judge's judge', was appointed to the High Court on the advice of a government led by Sir Robert Menzies and served as counsel assisting the Petrov Inquiry ('Mr Justice Windeyer', 32 ALJ 158). He was moved to say the following:

In *Damjanovic's Case*, I referred to the dissenting judgment of Holmes J in *Baldwin v Missouri*. I adopted as pertinent to s. 92 his remark concerning the Fourteenth Amendment: 'I cannot believe that the Amendment was intended to give us carte blanche to embody our economic or moral beliefs in its prohibitions'. I add to that his expression of 'the more than anxiety that I feel at the ever-increasing scope given to the Fourteenth Amendment in cutting down what I believe to be the constitutional rights of the States'. It seems to me that an ever-increasing scope is sought for s.92 too. I am, of course, not concerned, as Holmes J was, by this as a cutting down of State rights. That does not arise in Australia. What does cause me anxiety is the still greater danger of us putting more and more matters outside the authority of all the parliaments of Australia, Commonwealth and State. (*S.O.S. (Mowbray) Pty Ltd v Mead* (1971-1972) 124 CLR 529, 574; footnotes omitted)

Admittedly, that attitude was not typical of those justices appointed during the Menzies era.

The problem for liberal constitutionalism in Australia is one of cultural attitudes. Alexander Hamilton long ago pointed out that parchment constitutional guarantees are of no purpose or effect unless they enjoy the support of public opinion (Lodge, 1888:537-8). Australian politics has ceased to rest, to even the smallest extent, on principles. It represents a triumph of utilitarianism.

Forcing named oil companies to sell all but a statutorily specified number of petrol outlets, an allocation determined by no recital of principle available for scrutiny on the face of the statute, did not cause the Fraser Government qualms (see the Schedule to Petroleum Retail Marketing Sites Act 1980). Moreover, draconian retrospective taxation was passed under that government (Taxation (Unpaid Company Tax) Assessment Act 1982). Further, banning one trade union, the BLF, on principles applicable to no other trade union did not seem to unsettle the present government (Building Industry Act 1985 and Builders Labourers' Federation (Cancellation of Registration) Act 1986) — any more than the setting up of an *in camera* inquiry by statute (Parliamentary Commission of Inquiry Act 1986) into one judge, the late Murphy J, with its powers and composition crafted for the occasion, with no question of the legislation applying to other judges for the future, seems to have caused either the government or opposition to have pangs of principle. At least no one acted on them.

Australian politics and culture are heavily utilitarian and are becoming more so. The existence of this orientation is well exemplified

by Russell Schneider's description of the two wings of the Victorian Liberal Party:

[The small-l Liberal stream] was bitterly opposed to such things as racism but would never legislate against it, for to do so would be anti-liberal. The stream that was reflected in the seventies and eighties by Fraserism was decidedly authoritarian; it would embrace issues such as racism for the best of reasons, but then attempt totally illiberal methods to get its way. (Schneider, 1981:19)

Utilitarianism, from the first, has never chafed at illiberal methods, as witness Bentham's attacks on the privilege against self-incrimination (e.g., Hart, 1982:37,52).

Indeed, utilitarian considerations for many years kept Australia's roads chained by arbitrary administrative discretions as to interstate motor carriage, notwithstanding section 92's promise of freedom and the inconsistency of such an approach with a whole line of cases on schemes of agricultural marketing. For instance, Sir George Rich posed the question of whether arbitrary road transport licensing was constitutional:

The question which I have to ask myself is whether, in a scheme which allows complete freedom to go or to send from one place to another but in the process of co-ordinating the means and of rationalizing the facilities, denies a completely unregulated choice of means, a direct restraint upon or interference with trade, commerce, or intercourse is imposed. (*R. v Vizzard; Ex parte Hill* (1933) 50 CLR 30, 51)

His Honour found in favour of the scheme.

The strongest antidote to full-blown utilitarianism in Australian culture has historically been a classical education. The past is riddled with despotism, its methods and ultimate failure. A knowledge of ancient history, as well as a solid understanding of the history of England in the 17th century, has been an intellectual bulwark of individual liberty and rights, as well as of the importance of judicial independence and the decentralisation of government. Despotism, even in the pursuit of noble ends, is usually unattractive to such scholars, at least those raised in the English tradition.

Sir Garfield Barwick said on the death of Sir Owen Dixon:

Throughout his life he retained his interest in the classics, and their influence upon him continued ... Our generation has radically changed educational curricula. It remains yet to be seen whether the changed methods, given equal intellectual

capacity and inclination, will produce as rich a mind as that which Sir Owen developed over the long years of his life and experience. ('The Late Sir Owen Dixon' (1972) 126 CLR v. vi)

Clearly, that bulwark has gone.

Our history and traditions provide no substitute. John Hart Ely quotes Garry Wills that, 'Running men out of town on a rail is at least as much an American tradition as declaring unalienable rights' (Ely, 1980:60). In Australia, there is no tradition of declaring such rights. There is therefore little support for constitutional limitations within popular culture.

While, with all due respect, the courts could no doubt do better, there is not the support for such an effort in this country. Where there is not the public support for principles of liberal constitutionalism, there is very little chance they will be observed.

Sir Robert Menzies, as noted already, was a dear friend of Sir Owen Dixon's and his respect and support did not falter despite the striking down of the Communist Party Dissolution Act 1950 (*Australian Communist Party v Commonwealth* (1951) CLR 1). For much of the period Sir Robert's opponent was Dr Evatt, who, as noted already, was Leader of the Opposition and a former High Court judge. While Dr Evatt has had his share of critics from various perspectives, it would be churlish and less than generous to deny that he had a very strong personal attachment to the rule of law, as he perceived it (e.g. *Andrews v Diprose* (1937) 58 CLR 299; *R v Federal Court of Bankruptcy; Ex parte Lowenstein* (1937) 59 CLR 556; and *Deputy Federal Commissioner of Taxation v W.R. Moran Pty Ltd* (1939) 61 CLR 735).

In the result, attitudinally and intellectually, the Australia of today is vastly different from the Australia of only 30 years ago.

The whole situation is similar to the one described in 1949 by Professor Schumpeter:

Of all the things that have happened in England during the last two years nothing has struck me more vividly than has the weakness of the resistance that has been offered to advance along the socialist line ... [L]ess heat has been generated [in Parliament] by the issue of social reconstruction than by several secondary issues of the past ... Both in Parliament and in the country the important sector of the conservative party which envisages questions of social reconstruction with perfect equanimity has gained ground ... This is not the manner in which a strong nation reacts to attack upon principles to which it is firmly attached. I infer that the principle of free enterprise is no longer among them. Socialism has ceased to be resisted

with moral passion. It has become a matter to be discussed in terms of utilitarian arguments ... And this is the writing on the wall — proof that the ethos of capitalism is gone. (Schumpeter, 1976:416)

Judicial review has served Australia well in the past. It ushered in the years of prosperity of the 1950s and early 1960s by deregulating road transportation, thereby cutting the size of the country in half, vastly expanding commerce.

It has kept alive 'windows of opportunity' for the enterprising for years after some interest group or another determined that they, not the public, should settle who could serve people best. It blocked the nationalisation of banking (*Bank Nationalisation Case* (1949) 79 CLR 497). It gave commerce, as well as individual freedoms of conscience and speech, much reign, by respecting the careful division of authority between the States and federal parliament.

Indeed, the present deregulated structure of the money market is a result of Sir Robert Menzies' conscious refusal to try to apply the federal banking power to non-bank financial institutions (cf. Menzies, 1967:142-3). Hence, under State regulation the market grew to the point that such institutions could not be obliterated. Without the question of constitutionality, it is doubtful that control of non-bank financial institutions could have been resisted politically.

However, anyone who seeks to rely on the legal system to counter fundamental social and political change should think again. The judiciary can require a sober second look. The judiciary is generally in the rear of shifts in opinion, not in the vanguard. The judiciary is conservative in the very narrowest sense. The judiciary has done this, and still the demands rejected in the past have been repeated. It would be surprising if, in a democratic culture, the judiciary did not eventually mirror public opinion.

Constitutional limitations must be in men's hearts and minds before they can rise above parchment to strike down legislative acts that put party and factions above principles. While no doubt there is a dialogue of sorts between the bench and the people, it is a very muffled one. Anyone who yearns for a return to the foundations of the Western tradition must seek to have them accepted in the court of public opinion, before the courts of law.

## X. CONCLUSION

Indeed, the function of constitutional interpretation and judicial review has become largely redundant within the present environment. It would seem sensible to grant formally to the federal parliament the powers that

have been informally given to it by the High Court, namely, a power to govern Australia, subject to the requirement that a State or sufficient individuals may require any legislation to be put to a referendum where a majority of electors in a majority of States must approve it. This would cope with the utilitarian drift of our culture by acknowledging it and accommodating our institutions to it, instead of trying to set up counter-majoritarian institutions within a culture unable to perceive the legitimacy of such institutions. Precious judicial time could then be devoted to resolving private disputes, leaving politics to politicians.

If such a structure were to be settled upon, then a Constitutional Council composed of, say, 50 ordinary citizens selected by lot each twelve months should be established with power to police the constitutional integrity of the federal electoral franchise, the federal electoral process and free political speech, with any three members of the Council being able to black-ball legislation they believe infringes those rights, subject to the proviso that the parliament concerned may vote to put such legislation to a referendum in order to overcome the veto.

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# CONSTITUTIONAL ROUTES TO SMALLER GOVERNMENT

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# CONSTITUTIONAL ROUTES TO SMALLER GOVERNMENT

*Geoffrey Brennan*

## I. INTRODUCTION

The small government movement, including this volume, is an exercise in persuasion. But, who are we trying to persuade? And what is the nature of the problem whose solution we are trying to persuade them of?

To give point to these questions, let me make several preliminary observations:

1. When public goods are 'optimally provided' in the standard welfare economics sense, there will typically be some subset of citizens who would prefer to be provided with less of them. This is because tax institutions do not reflect marginal evaluations of public goods: I pay the same total tax as someone else with the same taxable income and consumption pattern, whatever our relative valuations of additional public spending. Therefore, the fact that some individuals — conceivably a majority — would prefer a reduction in public spending (and tax rates) does not imply that a reduction would increase 'efficiency' as conventionally understood.

2. If citizens rank public services from most-valued to least-valued, in the manner that economists sometimes assume, then all will consider the least-valued as the 'marginal expenditure'. If tastes for public programs differ considerably, then the marginal program will be valued less highly than the tax cost for every taxpayer. That is, we can probably get virtual unanimity on the proposition that there is some public expenditure program that ought to be cut — but no consensus on which that program is. On the other hand, we might also get unanimity on the proposition that there is some public expenditure program that ought to be expanded — again without consensus on which. In short, general expressions of sentiment about the size of the public sector are not easily interpreted, and might conceivably mean almost anything at all depending on which particular elements in the expenditure budget the taxpayer-citizen has in mind.

3. If any social outcome — including a political outcome — is conceived as representing some sort of equilibrium among competing forces, then it follows that if that outcome is to change, something in the forces that create that equilibrium must change. To put the same point a different way, we might quote Frank Knight's famous aphorism: '... to call a situation optimal is to call it hopeless — and vice versa'. Or, to put the point again slightly differently, to call a problem a 'problem' is to imply that there exists a feasible solution: a problem for which no feasible solution exists is properly described as a 'constraint'.

If these points are accepted, the diagnosis of a genuine 'problem' in connection with public sector size is not a trivial matter. It is only to be expected that a large number of individuals would like the public sector to be smaller and will exploit whatever influence they have to secure that end. In some measure, politics provides precisely the forum for those attempts at influence. Is our perception of the 'problem' of large government ultimately anything other than an expression of our own tastes for public activity?

If it is, it must be the case that pretty well everyone can be made better off by having a smaller public sector — and the exercise in persuasion is to show why that is so. Let me say, further, that if it is so, it cannot be so obviously — since otherwise citizen-voters would have done whatever they could to solve the problem. That is, rational agents do not sit around knowing that there is some action that could make them all better off. Mutual gains are 'free lunches' and do not remain unclaimed for long.

So what is it that we know that they don't? And what is the action that can make all better off?

I suggest that what we know (or think we do) is something about the workings of democratic political process — namely, that it generates a level of public activity that is larger than the one that maximises gains from trade. I shall say a little about how this comes to be the case in what follows, but here I want to make a more general remark — that if the problem is one of how democratic processes work, then the solution will require changes in our political institutions of one kind or another. There is not much point in preaching to the politicians if the cost to them of heeding our sermons is that they get thrown out of office! We have rather to change the rules of the political game so that even those politicians who don't heed our sermons will be encouraged (or constrained) to produce public budgets of the proper size. I shall refer to such changes in the 'rules of the political game' as 'constitutional', following the usage of James Buchanan. It should be clear that constitutional changes so defined do not necessarily have to be written down in some constitutional document: various sorts of unwritten conventions, gentlemen's agreements and so on also qualify. What is

crucial is that the domain of policy action is the institutions or rules of politics, not the particular outcomes.

An example might help to elucidate the notion of 'constitutional' change, as I have defined it here. The example is not taken from politics, but the analogy should be clear. Suppose you are a professor of economics presiding over a department that has high failure rates in the first year. The university bureaucracy insists that the teaching performance is inadequate and that, without any lowering of standards, pass rates must rise. So, you allocate your best teachers to Economics I, and tell them to try hard and to teach as well as they can. Inspire them, so that they might inspire the students! This is a non-constitutional solution. But, after a quick reading of Adam Smith, you suddenly hit on a different plan. You decide on a syllabus, and set a final exam on it which the staff don't know (so as to preserve standards). Then you allocate three or four of the staff to teach Economics I, and you pay each teacher not a fixed salary but a fee for each of their students that pass — say \$100 each. Students are free to choose which teacher to attach themselves to, but must register for the exam as someone's student. This is a 'constitutional' solution in that you have changed the institutional arrangements so that teachers have an increased incentive both to get students and to get those students through. Perhaps the Bond university, unfettered by academic bureaucracy, might try it!

What we seek in the political arena is to secure a set of incentives for politicians and/or constraints under which they operate, so that budgets of the 'correct' size are generated. Moreover, identifying which budget size is correct is intimately connected with the properties of the process that generates it. If, to take the simple undergraduate example, I have six oranges and two apples and you have three oranges and four apples, how can an observer tell if that allocation is 'efficient' or not? He can't. If, on the other hand, he observes you and me arriving at some allocation — whatever it is — by voluntary exchange up to saturation, then he can conclude that at least the allocation that prevails is preferred by both to the original allocation and perhaps, more strongly, that we are both as well off as we can be given the relevant constraints. It is a perception of the nature of the market process, informed by a general theoretical understanding of how markets work, that enables us to evaluate what we observe. Equally, if by general analytic reasoning we can identify specific biases in majoritarian electoral politics or democratic process more generally, then we can reasonably identify measures that seem likely to lead to superior outcomes. And indeed, this seems to me to be the only way we can proceed. General analytical presumption is, in other words, a crucial part of the relevant evidence, because we cannot identify empirically the 'optimal' size of the public sector. As in the oranges/apples case, the outcome does not speak for itself. To be sure, we may identify empirical anomalies. We might for

example ask, in the light of the spectacular growth of the public sector this century, whether it is the case that the public sector in 1910 was, after all, miles too small on efficiency grounds. And if so, why? Or, if our reasons for believing that the public sector is overlarge relate, say, to increased centralisation of the political process, we might take the trouble to check whether relatively decentralised politics (federal systems, perhaps) are in fact smaller *ceteris paribus* than more centralised ones. Empirical investigation is, therefore, relevant as a check on claims made, but it cannot in itself answer the crucial question — whether the public sector is too large or not.

In what follows, I shall begin by isolating various 'reasons' for believing that democratic politics might generate excessive budgets, and briefly indicate the possible constitutional solutions to the problem so identified. The approach here is somewhat taxonomic, and the discussion brief. But it may raise a few signposts for discussion.

I shall then turn to a more detailed examination of various kinds of direct limits that might constitutionally be imposed on the revenue-raising side of government. This is really an investigation of the constraining capacity of different forms of tax limits. Such an investigation in some ways already assumes that which is to be proven — namely, that the public sector is inefficiently large. Some will, I am sure, consider this to be self-evident. But in my view, the onus of proof lies with those of us who hold that position.

## II. A DIAGNOSIS

Why do we believe the public sector to be too large on efficiency grounds? What is it about the workings of democratic politics that tends to generate budgets that are excessively large? There are a number of answers that have been suggested in the literature, and I mention them here now.

### **The Role of Special Interests**

It is sometimes argued that special interests, in the pursuit of their own gain, generate a redistributive process in politics in which each of these smaller well-defined cohesive groups exploits the general taxpayer-citizen. In the limit, it can be the case that each citizen in his capacity as a member of some special interest group is involved in 'ripping off' all others, in a process where all lose out in toto.

Consider a simple example. Suppose there are five groups, each with its own 'special interest' project (e.g. a college of advanced education located in its electorate). Suppose the benefit of each project to the group is \$4m and the total cost for each is \$5m. The project

would not go ahead if A had to pay for its own project. However, because each project is public the cost is spread equally across all groups: each group pays \$1m toward each project. Suppose now that A goes to B and C and agrees with each to vote for their projects if they will vote for his. Then a majority coalition forms for A's project, and it proceeds. Suppose that B makes a similar deal with D, and C with E, and that D and E do a similar deal between them. Then the set of coalitions is set out in Table 1.

Table 1  
Special Interest Coalitions

Project	Supporting Coalition	Cost to Coalition Members	Total Cost	Benefit
A's	A, B and C	\$3m	\$5m	\$4m
B's	A, B and D	"	"	"
C's	A, C and E	"	"	"
D's	B, D and E	"	"	"
E's	D, E and C	"	"	"
Total			\$25m	\$20m

In this example all are made worse off by a set of projects that are politically viable. In principle, all could be made better off by closing down all projects. But no one has any incentive to axe all such projects. Rather they have an incentive to restrict coalition formation — the best feasible outcome for A is where A, B and C form a majority coalition and vote only for their own projects. Then three projects proceed, and D and E are fleeced at the others' expense. From A, B and C's viewpoint, this clearly dominates an outcome in which there are no special interest projects.

Several things are notable about this line of reasoning, however. Note that the 'special project' that each group desires may be a tax cut in its own favour. The general presumption of overexpansion depends on expenditures being of special interest, while taxes are uniform. There would be underexpansion if expenditures gave general benefits, while tax cuts were of special interest. In practice, it may be the case in general that taxes do tend to be more uniform than expenditures in their distributive effects, but both sides of the budget are equally susceptible in principle to special interest manipulation. In that sense, the argument here is as much about the composition of the public budget as about its size: genuinely public goods of the 'national' kind will tend to be

underexpanded, while public provision of private goods will tend to be overexpanded.

What constitutional solutions suggest themselves to this problem? There are several — none of them ideal:

(i) **Increase the size of the majority required for expenditure projects to proceed.** This is what we might loosely call the Wicksellian Solution, and clearly it does increase the cost of special interest projects to the decisive coalition(s). An 80 per cent majority would raise the price of a special interest project from 50 cents per dollar of cost to 80 cents. However, as emphasised by Buchanan and Tullock in *The Calculus of Consent*, this also raises the cost of decision making, and conceivably genuinely desirable projects may be axed.

(ii) **Require uniformity on both the tax and expenditure sides of the budget.** This will reduce special interest legislation, but at the expense of making no allowance for genuinely different tastes for quasi-public goods. The community that values a CAE at \$6m cannot have it because other communities value the CAE at less than the \$5m cost. Nevertheless, uniformity restrictions such as do exist in many democratic states do have a rationale along such lines, and should not be lightly overturned.

(iii) **Decentralise tax and expenditure decisions to the level of benefit.** To the extent that special interest coalitions are regionally defined, this sort of federalist solution has some appeal. If A has to pay for its own CAE, it is more likely to make a sensible political decision. But coalitions can and do form on bases other than geography (although with a system of geographically defined electorates, such coalitions are disproportionately favoured). And natural tax and expenditure jurisdictions may not overlap — as when taxes are exported to other jurisdictions. In short, political decentralisation will not necessarily solve the problem, and may involve other considerations that also tend to encourage excessive budgets.

### **The Time Horizons of Ruling Coalitions**

Electoral horizons are characteristically shorter than are individuals' horizons in market contexts. The current majority is in office only for a given electoral period. Beyond that time there is a distinct possibility that the current party/incumbent/majority coalition will be replaced. Accordingly, benefits — particularly those that provide room for new projects (including tax cuts) — that will accrue after the current electoral period ends will be heavily discounted. For example, suppose A, B and C are the currently decisive coalition and can undertake an investment in tax reform that will yield extra tax revenue only five years hence. They recognise that there is only a 50-50 chance, say, that they will be the decisive coalition at that time. Then they will make the investment

only if the costs are less than half the benefits in ordinary present value terms.

This argument on its face seems to suggest an underexpanded rather than overexpanded public sector. But it has been emphasised that if governments have access to public debt, they can raid the tax-raising capacity of future governments — spend now, in recognition of the reduced probability of having to face the consequences of current profligacy in the future.

There are two obvious solutions to this problem:

(i) **Increase the term of office.** There are obviously clear issues of democratic principle — electoral accountability, specifically — that argue against this course. However, it is worth noting that election periods can be too short as well as too long, and not just because constant elections are tedious for voters and time-consuming for politicians.

(ii) **Require that all budgets be balanced.** The enthusiasm for a balanced budget amendment, as it exists in some circles in the US, depends on an argument along these lines. If the constitution were to ban debt, so the argument goes, the scope for excessive current spending at the expense of future taxpayers would be significantly inhibited. I do not intend here to argue the pros and cons of a balanced budget amendment, though I do not believe that the logic all goes in the one direction. For one thing, if political time horizons are too short, the capital budget of the fisc will tend to be underexpanded, and there will be a tendency for governments to run down the 'national estate'. Both these tendencies seem likely to be exacerbated by the removal of access to debt.

### **The Special Interests of Bureaucrats and Politicians**

So far we have spoken as if the only discretionary actors in politics were citizen-voter-taxpayers — as if political agents (bureaucrats and politicians) were simply puppets acting out the dictates of the majoritarian electoral system. There seems little doubt, however, that those political agents do exercise genuine discretionary power — and moreover, that as a group they do have an identifiable set of 'interests'. These interests involve the extension of their own domains of influence. Political agents tend to have an interest in the exercise of power — in some cases for its own sake, in some cases in the advance of some deeply held moral or ideological conviction. There tends to be a certain 'imperial imperative' — whether it be empire-building in some corner of the bureaucracy, or the simple conviction that one really ought to be doing something about something.

All this tends to build a distinct bias into government action. The significance of the political agent's life is caught up intimately with

what he or she can achieve — and although cutting down his or her own level of power and influence is doubtless an achievement of sorts, it is not necessarily the most obvious or the most attractive. Those agents in government that move towards deregulation, and fiscal parsimony, usually do so in a context where there is more power and/or expanded activity for themselves — more influence for the Finance portfolio; more economists for the 'financial management' sections of Treasury; and so on.

Consequently, while it would doubtless be simplistic to portray government as a monolithic revenue/expenditure-maximising machine, exploiting an ignorant and relatively powerless electorate, we nevertheless ought to take account of a general tendency on the part of political agents to promote their own interests: on average over the long haul, those interests tend to be in the direction of more power rather than less and larger public budgets rather than smaller.

There are however two questions that this observation poses. First, it is not clear how much influence on political outcomes such considerations exert. Is the budget 20 per cent too large, or 40 per cent, or 100 per cent? Second, to the extent that this increased budget size arises from genuine 'own-demand' of bureaucrats and politicians for public output, it is not obvious that such demand should be considered irrelevant. If, for example, determined do-gooder A wishes to increase redistribution towards single parents, to what extent is A's demand for such redistribution irrelevant in any proper normative calculus?

My own response to these difficulties is along the following lines. With respect to the relevance of politician/bureaucrat's own-demand for policies, I am inclined to take the line that it is only to the extent that such individuals would pay for such policies out of income over which they had complete discretion that own-demand should count. Since politicians and bureaucrats do not have complete discretion over public funds — and cannot, specifically, pay such funds to themselves directly in higher salaries — one cannot properly attribute all, or even most, of the public expenditure to bureaucrat/politician own-demand.

With respect to the magnitude of the 'supply-side' effects, I am simply uncertain — and such uncertainty seems to me to be the only intellectually respectable position. However, where there are institutional arrangements that seem to rely too heavily on the goodwill of bureaucrats and politicians — where, in other words, democratic constraints seem excessively loose — it seems to me that we ought to move to tighten those constraints. On such grounds, the sorts of constitutional solutions to this problem that suggest themselves are ones that we might wish to support anyway on grounds of general democratic principle — such as a constitutional requirement to index the tax rate structure, or a restriction on the use of off-budget expenditures, or restrictions on the creation of quangos, and so on. As the Australian

experience with tax indexation suggests, such policies, if they are to be effective, must be given some quasi-constitutional status. Otherwise, governments will find good reason — and excellent rationalisation — for making exceptions, and over time the force of the restrictions will be eroded.

### III. CONSTITUTIONAL USE OF TAX LIMITS

Suppose that one were convinced, for whatever reason, that the public sector is too large in some meaningful sense and that some direct restriction on the size of the budget is called for. Then it is natural to look at general tax limitation proposals of one kind or another. In order to examine the efficacy of such limitation proposals, it is natural and analytically useful to assume that government is a simple revenue-maximiser, and that is the assumption about government motivations I shall make in what follows.

Alternative tax limitation possibilities can be broadly categorised according to the aspect of the tax or tax system that is subject to restriction. Accordingly, we distinguish between limits imposed: first, on tax revenues; second, on tax bases; third, on tax rates.

**Revenue Limits.** In this case, the constraint takes the form of specifying a maximum amount of revenue that a government may obtain from a particular tax or tax system. The revenue maximum might involve an absolute magnitude, or perhaps more likely a share of the jurisdiction's total income or total product. The latter type we might refer to as 'share limits'. They are more commonly applied as restrictions on total budget size (or revenue from a total tax system, broadly defined) than as restrictions on particular taxes.

**Base Limits.** Base limits take the form of restriction on the bases to which government may have access in acquiring revenue. These limits may specify the revenue instruments government may use, or those revenue instruments government may not use. The assignment of the property tax to local governments might be an example of the former; 'balanced budget limitation' is an example of the latter in the sense that it denies government access to debt issue as a revenue-raising device.

**Rate Limits.** Rate limits can take a number of forms. Restrictions may be placed on the level of rates — usually in the form of a maximum limit above which rates cannot extend. Alternatively, restrictions may be placed on the allowable rate structure — that it should be proportional, or that it should be uniform across individuals or across commodities.

In what follows I shall examine these various possibilities in turn, with an eye both to how effective they might be in constraining a

revenue-maximising government and to how efficient they are in achieving a given degree of limitation. The use of these two criteria indicates the normative underpinnings of the evaluation procedure. I believe that what emerges from consensus at the constitutional level has considerable normative authority. Thus, predictions about what would emerge from the individual's calculus at the constitutional level become the means not only for understanding the current tax limitation movement but also for evaluating it.

#### IV. SHARE LIMITS

Understandably perhaps, share limits seem to hold a peculiar fascination for economists. The idea of specifying a limit to the size of government as a share of some economic aggregate (more or less well defined), such as gross product or total income for the relevant political jurisdiction, seems to offer a direct way of limiting public activity. But these ratio-type constraints are likely to be much more congenial to the professional economist/consultant than to the practising politician or the average taxpayer. The economic sophistication required on the part of the citizens (and politicians) whose support must be organised to implement any constitutional change can represent a major barrier to the electoral success of this type of constraint. Taxpayers tend to think in terms of specific levies, and of their own treatment under such levies by the taxing authorities. They do not think in terms of such abstractions as total tax revenue or total spending, and surely not in terms of the ratio between two abstract entities, total budgets and total product or income.

But setting these problems of electoral psychology aside, are there any purely technical problems that ratio limits seem likely to pose? There are two that seem to me particularly important — one relating to whether the limits are effective, and the other relating to whether those effective limits are achieved in the most desirable way.

First, there is a problem as to where the share limit should be set. This is complicated by the fact that there is no simple one-to-one connection between revenue level and 'public output' in any meaningful sense. Consider, for example, some publicly provided good such as education. Clearly, the government can achieve a desired level, either by direct provision of education (i.e. it can tax individuals and provide the service free of direct charge) or by subsidising private provision. And the subsidy in question may take the form of vouchers (or direct subsidy of some other type) or tax concessions. In principle each of these alternatives could produce precisely the same outcome, but they clearly involve quite different amounts of nominal tax revenue. The subsidising of private activity will typically achieve a larger response per dollar of revenue raised than direct provision; conversely, for any given level of

activity, subsidy will typically involve less tax revenue than direct provision. Subsidies given as direct payments will likewise involve more nominal tax revenue and a higher nominal government budget than tax concessions that induce an identical private response. At the very least therefore we should require that such 'tax expenditures' be incorporated into the relevant measure of total revenue for 'share limit' purposes.

But this in turn raises the question of whether we ought also to distinguish between subsidies and direct provision; for, as I have observed, an identical amount of revenue can involve a different level of government influence depending on the form of government action. Even if the implicit subsidy embodied in 'tax-expenditures' is made explicit, therefore, the problem associated with translating any given revenue figure into some measure of government 'output' remains. And there are important conceptual issues at stake in this. Is it clear, for example, that we wish to minimise government 'output' or influence, independently of its revenue cost? Is there a distinction to be drawn between policies that involve revenues passing through the hands of government agencies, and those that do not? I do not attempt to answer these questions here. But it does seem clear that any share limit that accurately reflected what it is we wish to measure would be extremely complex and itself somewhat open to debate, and the problems of electoral ignorance would be correspondingly aggravated. Equally, the extent to which an aggregate revenue limit would succeed in achieving the objective of placing limits on government activity seems open to some doubt.

Suppose, however, that in the presence of this maximum share (appropriately defined), government is genuinely constrained. Nevertheless, government can achieve its maximum share in a variety of ways between which the citizen-taxpayer behind the veil of ignorance could not be expected to be indifferent. For example, different tax arrangements will induce different excess burdens: in the extreme case government could exploit tax instruments considerably beyond their maximum revenue limits and the excess burden induced by the tax could be many times greater than the revenue raised. There is nothing inherent in the nature of share limits that would give government the incentive to seek out broadly based, minimally distorting taxes. As we have already seen, the government, on the contrary, has the incentive to acquire its revenue limit by the application of very high rates to a base made narrow by strategic concessions. Whether these high rates raise much or indeed any revenue is largely beyond the point: the associated excess burdens seem likely to be very substantial indeed.

**V. BASE LIMITS**

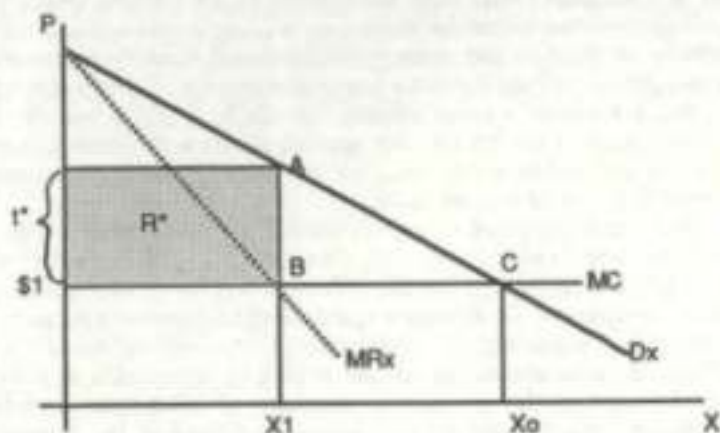
The possibility of constraining the activities of government by specifying the bases on which taxes may be levied does not seem to have attracted much attention in the tax limitation context. Perhaps the reason for this is that it seems to set much of the standard public finance literature on its head. The virtues of broad-based, 'comprehensive' taxes are replaced by an explicit preference for the appropriately narrow tax base — 'appropriate' in that when the maximum revenue rate is applied, the revenue yield is exactly that required to supply the level of public goods that citizens expect to desire in future periods. Yet it is clear that if the government is constitutionally restricted to particular taxes with well-defined bases, its revenue share is necessarily restricted, and especially so as the activities excluded from taxation are substitutable for those upon which taxes may be levied.

Consider an apparently extreme, but still relevant, example. Suppose that government is allowed to levy personal taxes on money incomes but that it is constitutionally prohibited from taxing income-in-kind. In such a setting, as income tax rates increase, taxpayers will, of course, shift toward income-in-kind. This shift generates an excess burden, familiar from analyses of welfare economics. What economists have overlooked, however, is the constraining influence that such potential shifts can exert on government's fiscal appetites. Faced with the prospect that taxpayers can, and will, shift to non-taxable options, even if at some cost, governments will find that maximal-revenue limits are attained at much lower budgetary levels than would be the case if the tax base should be fully 'comprehensive'.

The illustrative analytics of Figure 1 may be helpful here. Suppose that  $D_X$  indicates aggregate demand within the taxable community for some good  $X$ , and that  $X$  has been assigned to the government as the base. For analytic simplicity, I assume that  $D_X$  is linear and that  $X$  is produced under conditions of constant costs. I define the units of  $X$  in terms of a 'dollar's worth', so that marginal cost is everywhere one dollar, and  $X_0$  is the total pre-tax expenditure on  $X$ . To avoid the possibility of various forms of 'discrimination', I assume that the government is limited by a requirement that the tax rate structure be uniform both across units of  $X$  and between individuals. What uniform proportional tax on  $X$  will government choose, given its revenue-maximising proclivities?

This question is analytically identical to asking what price a profit-maximising monopolist would charge for  $X$  if he were assigned a monopoly franchise in the sale of  $X$ : tax revenues in the one case are exactly equivalent to profits in the other. As is well known, we can determine the profit-maximising output-price combination by construc-

Figure 1  
Revenue-Maximising Under Tax-Base Limits



ting a marginal revenue curve,  $MR_x$ , which intersects the dollar  $MC$  line at  $X_1$ : this output is the profit-maximising output and  $AX_1$  the corresponding profit-maximising price. Analogously, the tax-revenue maximum involves a gross-of-tax price of  $AX_1$ , and a per unit tax of  $(AX_1 - 1)$  dollars: the tax rate involved is  $t^*$  (given by  $[AX_1 - 1]/1$ ) and the revenue obtained is  $(t^* \times X_1)$ , shown as the shaded area  $R^*$  in Figure 1.

We should note at this point that in this linear case, the  $MR_x$  curve necessarily bisects the horizontal distance between the  $D_x$  curve and the vertical axis at any price. In particular,  $X_1$  is exactly one-half  $X_0$ . It follows that the excess burden induced by the maximum revenue tax, the 'welfare triangle'  $ABC$ , has an area exactly one-half of  $R^*$ .

Two things follow from this observation. First, if we consider assigning to government some broader tax base, it is clear that this same revenue  $R^*$  could be obtained at a smaller welfare loss. This is the observation on which the traditional 'efficiency' preference for broad-based taxes is founded. However, assignment of a broader tax base to government would, under Leviathan assumptions, simply lead to a larger maximum revenue yield. This would not only increase the level of public spending, possibly beyond desired limits, but also would increase correspondingly the excess burden attributable to taxation (to one-half of the new and higher maximum revenue yield). Thus, revenue limits imposed via the assignment of limited tax bases also set limits on the welfare losses attributable to taxation.

Second, the use of base limits as opposed to share limits ensures that the welfare loss attributable to taxation can never exceed one-half of revenue raised. As pointed out in the previous section, it is conceivable that in the share limits case tax rates may be pushed above their maximum revenue values, in which case welfare losses will exceed half the revenue obtained, and in the limit will absorb virtually all consumer surplus generated from X. If the practical relevance of this possibility is doubted, it needs to be asked whether one can be sure that the very high marginal rates of tax historically applied in some Western countries, above 90 per cent in some cases, are not already above the maximum revenue limits of the relevant taxes.

The implications of this discussion for conventional tax policy should perhaps be underlined. The overwhelming preference for broad-based taxes that characterises tax policy orthodoxy is exposed here as extremely dubious. To the extent that government behaves according to the revenue-maximising assumptions postulated here, or equally, to the extent that constitutional tax limitation is to be interpreted as a widely shared desire on the part of the citizenry to inhibit the growth of government, the familiar policy recommendations of tax economists must be recognised as heading in precisely the wrong direction. Broader-based taxes will ultimately lead to larger revenues being collected than otherwise, with concomitantly larger levels of public goods supply than the citizenry desires at current prices, and larger levels of fiscal exploitation.

There is one possible virtue of base limits that does not seem to be present under direct revenue limits or rate limits. This is the possibility of using appropriately chosen tax-base constraints to establish incentives for governments or governmental agencies to provide the goods and services valued by the taxpayers themselves rather than prerequisites of bureaucratic office. If the constitutionally allowable bases for taxation are chosen so as to be strongly complementary to the public goods to be provided, governments will find it necessary to perform with tolerable efficiency in order to collect tax revenues. A highway agency, for example, charged with producing and maintaining roads, will be motivated to fulfil its assigned function if its revenue base is restricted to gasoline and vehicle levies, because the better the roads, the more gasoline will be purchased and the larger and more expensive the cars bought and hence the more revenue the surplus-maximising agency will provide. Likewise, a government television network will tend to operate in viewers' interests if programs are financed by the sale of television-watching licences. In the extreme case, this establishes an argument for public provision of services for direct fees and charges. By appropriate choice of tax base, the proportion of revenue expended by government on the goods citizens want can be increased, and this may be an important feature of base limitation as a means of constraining government.

Although it is not possible to explore 'balanced budget limits' in this setting, it should be clear that these may be interpreted as a form of base limitation. Under a balanced budget restriction, however, government access to allowable revenue sources is constrained not by specifying the tax instruments that government may use — but rather those that government may not. A balanced budget amendment denies government access to debt issue and restricts its access to new money creation as revenue-raising devices. An assessment of the virtues of such an amendment would involve an evaluation both of the peculiar vices of new money creation and debt issue under revenue-maximising assumptions — peculiar, in the sense that they do not apply to other revenue instruments — and of the influence that the removal of these instruments from the government's armoury would have on its total revenue capacity. I shall not, however, attempt to discuss these issues here.

Finally, it should be emphasised that the success of any form of revenue limitation, whether implemented by base limits or direct revenue limits, depends on the existence of additional constraints on governmental regulatory powers. Just as discretionary exercise of tax concessions can achieve government objectives at very low revenue cost, regulations — and the exercise of power by fiat more generally — can be used to substitute for budgetary expenditures. One would expect that the direct exercise of legislative power would be used much more extensively as revenue limits, however imposed, are approached. Constitutional rules that limit government access to regulation could be devised. Some already exist. And it could be that, to the extent that reducing government revenues also reduces the size of the bureaucratic machine in which regulations and their enforcement are born, revenue limits and limits on rule by regulation are over some range complementary. For my purposes here, I simply note the need for such constraints in genuine constitutional reform.

## VI. TAX RATE LIMITS

Rate limits can take two forms: limits on maximum rates that can be imposed; and limits on the rate structure. I examine these in turn.

### Maximum Rate Limits

Maximum rate limits are simple to comprehend and relatively easy to apply. In conjunction with base limits, they represent a direct and efficient means of restricting government access to revenue. In the absence of base limits, however, they are unlikely to be genuinely constraining. For suppose that a maximum rate limit were imposed in

isolation. The immediate result would be that the government would be forced into widening the tax base in order to secure revenues. At first glance, this may seem to be a desirable thing; by setting the rate limit low enough, the citizen-taxpayer could ensure that a genuinely comprehensive tax would raise the revenue required to finance the level of public goods supply he or she expects to want. And given the widely vaunted virtues of comprehensiveness in the tax system, the government would seem to have the incentive to provide a tax system that is genuinely desirable. Clearly, however, the forces that lead government to broaden the tax base do not stop when an acceptably broad base is reached: the revenue-maximising government cannot be expected to stop obligingly when some conceptual 'horizontal equity' norm is achieved. A tax on gross rather than net income might, for example, be instituted. And as well as the maximum rate income tax, we would expect the maximum rate sales tax, the maximum rate company income tax, the maximum rate payroll tax, the maximum rate wealth tax, the maximum rate estate duty, and so on. In the limit, government would appropriate revenue up to the natural limits set by individuals' preparedness to work, to save, to take risks and so on. In general, one would expect this level of revenue to go well beyond what the citizen-taxpayer would desire — and, of course, these natural limits would be operative whether maximum rate restrictions were imposed or not. Of themselves, therefore, rate limits do not in any way ultimately constrain the level of revenues — though they may force governments to collect the available revenue in expensive and inefficient ways.

It is clear, however, that when base limits are also operative, rate limits can be used to ensure revenue collection with minimal excess burden. Recall that with base limits used in isolation, the welfare loss under revenue-maximising rates will be exactly half the maximum revenue. Suppose we consider two alternative tax bases, X and Y, and Y is the larger; suppose further that X yields a maximum revenue,  $R^*_x$ , that provides the level of public goods supply citizens want. Under base limitation alone, X will be the preferred tax base since Y will yield too much revenue. But there is a tax rate,  $t_y$ , which, when imposed on the larger base Y, will yield the same revenue,  $R^*_x$ , as the maximum revenue from X. Assignment of base Y together with a maximum rate limit of  $t_y$  will, of course, yield that same revenue at smaller welfare loss, just as the traditional analysis assures us. The orthodox tax analysis, therefore, could be looked on as implicitly assuming an appropriate maximum rate constraint: the appropriate maximum rate must however be jointly determined with the base to yield the desired level of revenue. The equi-revenue assumption familiar from orthodox tax analysis becomes institutionally relevant only if there are appropriate constitutional restrictions to ensure that revenue cannot increase.

### Rate Structure Limits

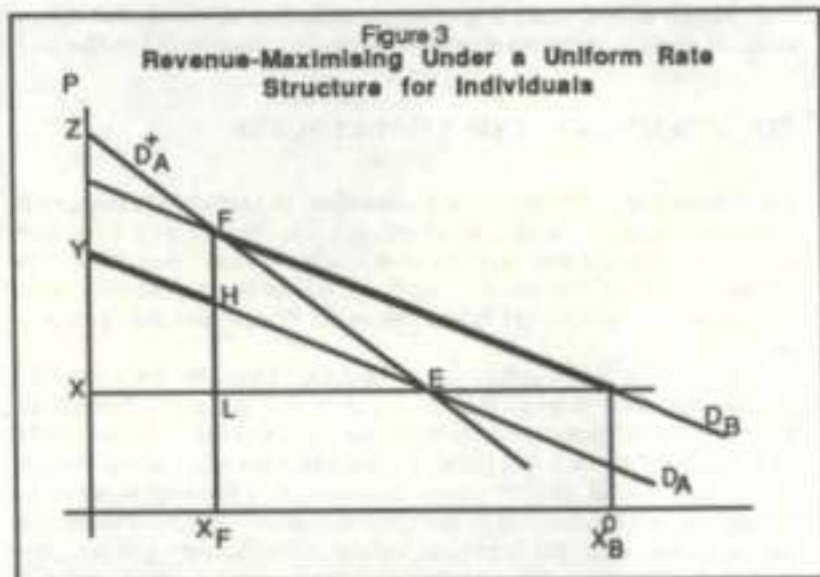
We have already noted the analogy between assigning Leviathan some taxable base  $X$  and assigning Leviathan a monopoly franchise in the sale of  $X$ . Carrying this analogy further, we should note that a profit-maximising monopolist can obtain larger profits from the sale of  $X$  than those indicated in Figure 1, by various forms of discrimination: discrimination over units of  $X$ , or between different consumers of  $X$ . In the same way, the revenue-maximising government can use the rate structure effectively to discriminate over units of  $X$ , and/or between different taxpayers. Such discrimination may increase public revenue — and therefore appropriate restrictions on the rate structure can be a means of tax limitation, just as maximum rate limits can be.

Consider the simple two-person example set out in Figure 2. Individuals  $A$  and  $B$  have demand curves for the assigned tax base,  $X$ , designated by  $D_A$  and  $D_B$ . The aggregate demand for  $X$  is  $D_T$ . Suppose there is a legal restriction that requires uniformity of tax treatment of  $A$  and  $B$ , in the sense that  $A$  and  $B$  must face the same rate structure. The revenue-maximising rate chosen will be  $t^*$ , derived from the aggregate demand curve  $D_T$  and the associated marginal revenue curve. In the absence of the uniformity restriction, however, Leviathan could impose the proportional rate on  $A$  that maximises the revenue obtained from  $A$  (shown as  $t^*_A$  in Figure 2, and determined from  $D_A$  in the same way as  $t^*$  is from  $D_T$ ) and the corresponding rate on  $B$  that maximises the revenue obtained from  $B$  (shown as  $t^*_B$  in Figure 2). This would increase tax revenues since, by definition, one is obtaining more revenue from each taxpayer than with  $t^*$ . Requiring uniformity as between taxpayers is, therefore, one means of restricting total revenue.

We should note that discrimination among individuals under a proportional rate regime does not have any efficiency advantages. The welfare loss for  $A$  is exactly half the revenue obtained from  $A$ ; likewise, for  $B$ . Hence, the aggregate welfare loss remains one-half of aggregate revenue.

Another form of discrimination is, of course, possible — this is discrimination over units of  $X$ . In the monopoly case, 'perfect' discrimination, appropriating the entire consumer surplus of all consumers, is an analytically familiar possibility. Here, precisely the same possibility appears. By setting a rate structure for each individual that follows that individual's demand curve, Leviathan can obtain as tax revenue the entire consumer surplus of  $X$  from each taxpayer. The rate structure for  $A$ , for example, would involve an initial rate infinitesimally below  $XY$  for the first unit of  $X$  and decline over the range to a zero rate at  $X^0_A$ . Each taxpayer would face a different regressive rate structure, and virtually all consumer surplus would be appropriated as public revenue.





government, along with or independently of base limits or direct revenue limits.

In evaluating the desirability of rate structure restrictions, however, a certain amount of care must be exercised. We should note that the perfectly discriminating regressive tax structure involves a zero welfare cost. Suppose that, under a proportional rate structure, the tax base assigned yields the level of public goods supply the citizenry wants. Since permitting a regressive rate structure would increase revenue levels, it might seem that this should be undesirable. However, it need not be. Consider again Figure 1. The maximum revenue  $R^*$  obtained under the revenue-maximising proportional tax,  $t^*$ , is exactly half the aggregate surplus given that  $D_X$  is linear, and the total cost in terms of consumer surplus from  $X$  forgone, which includes the excess burden, is  $3R^*/2$ . Allowing the 'perfectly discriminatory' regressive rate structure to be applied to  $X$  would therefore double the level of revenue and hence of public goods supply, and increase the cost in terms of consumer surplus forgone by one-third. It seems that only if the demand for public goods supply is extremely inelastic will the imposition of restrictions to prevent regression be desirable. We should note, however, that this proviso is strictly applicable to the case where the perfectly discriminatory tax rate structure is feasible: if imperfectly discriminatory tax rates are likely to be applied, then restrictions on the rate structure are more likely to be desirable. In any case, the advantages of discrimination appear only when discrimination over units (i.e. via a regressive rate structure) is applied: discrimination between

individuals in and of itself implies no reduction in excess burden per dollar of revenue, under revenue-maximising government behaviour.

## VII. SUMMARY AND CONCLUSIONS

The formal analysis of the fiscal constitution, in both its positive and its normative aspects, remains in its infancy. In this paper I have done little more than set the stage for discussion. I have attempted in the process to indicate how the analytic discussion of one aspect of the fiscal constitution — namely tax limitation, in its diverse possible guises — might go.

If there is a policy conclusion to be drawn from this discussion it is perhaps that there is more than one way to skin the governmental cat, and the alternatives are not necessarily all equally good. And we need to be reminded that much that passes for informed tax advocacy — indeed, much conventional analytics — is systematically eroding many of the natural tax limits embodied in our current system. Attempts to broaden tax bases, on ostensibly legitimate equity and efficiency grounds, may well lead in directions that the taxpayer-citizen does not wish to tread.

## COMMENTS

*George Winterton*

I wish to confine my comments to Dr O'Hair's paper.

Dr O'Hair contrasts 'evolutionary rationalism', which stresses the right of self-determination, with 'naive rationalism' or so-called 'utilitarianism', which is collective and authoritative.

Although Dr O'Hair speaks of 'utilitarianism', he does not appear really to mean that concept in the strict philosophical sense, which is itself a normative ethical theory. Rather he appears to use 'utilitarianism' to mean 'expediency'. He argues that utilitarianism leads to the destruction of moral limits in politics (p.287) — such as the rule of law and the concept of constitutional limitations on government.

I would question whether that is a necessary consequence of true utilitarianism, and would indeed maintain that it is at least arguable that the utilitarian principle of pursuing what will bring the greatest benefit to the greatest number of people would include the protection of individual freedoms and minority rights.

Dr O'Hair asserts that Australian politics and public life generally has lost its moral dimension (p.302). But this is merely asserted: he establishes neither that this dimension is currently absent, nor that it ever was present.

Indeed, Dr O'Hair asserts specifically that Australian culture is 'utilitarian' (p.302), but once again this is merely asserted — not established. And, as I have mentioned, he appears to equate utilitarianism with expediency.

His solution is to advocate a dramatic revision — indeed revolution — in the constitutional machinery.

I propose to focus attention on the penultimate point.

Is Dr O'Hair correct in asserting that Australian public life is devoid of a moral foundation? And do the High Court cases to which he refers establish this?

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Looking at the latter point first, they simply do not. I do not have time for a detailed examination of the cases to which Dr O'Hair refers, so let me summarise my view briefly.

While the paper clearly overstates the demise or impending demise of several constitutional principles and provisions — the separation of judicial power and federalism are supposedly 'dead letters' (p.292) and section 92 apparently 'will not see out the decade' (p.295) because it will also become a 'dead letter' once the views of Justices Stephen and Mason inevitably triumph (p.296) — it is undoubtedly true that the High Court's interpretation of several constitutional guarantees — sections 80, 99, and 116 — is highly questionable. But that in itself proves nothing. It certainly does not prove that constitutionalism has declined in the present generation, because most of these questionable interpretations date from an earlier period.

With all respect, the paper appears to adopt a simplistic calculus: decisions restricting State or federal power are good; those expanding it are bad.

But life and the Constitution are more complicated than that, as even the limited evidence presented in the paper demonstrates.

The same Justice Evatt who favoured the separation of judicial power and gave teeth to section 80 (both in *Lowenstein's* case, referred to on p.304) argued for a narrow view of section 92, one even allowing nationalisation of industries and banks.

And the same Justice Murphy, who interpreted Commonwealth powers broadly and sections 90 and 92 narrowly, has breathed new life into constitutional prohibitions such as sections 80 and 116 and even gone so far as to invent a whole catalogue of supposedly implied constitutional rights and freedoms.

Similarly, Dr O'Hair seems surprised to find a judge with Windeyer's credentials advocating limits to section 92 (pp.301-2).

But in reality none of this is at all surprising, because High Court decisions are much more likely to derive from attachment to consistent principles of constitutional interpretation than to manifest obedience to some overarching imperative of expediency or even utilitarianism.

Professor Leslie Zines's comparisons between the High Court's approach to the commerce power (section 51(i)) and the corporations power (section 51(xx)) is instructive here. He notes that the High Court has allowed the Commonwealth to control aspects of intrastate trade under the corporations power which are denied to it under the commerce power, even though they would have fallen within the scope of the United States commerce clause, which is virtually identical to ours. He comments:

Yet the contrast between the careful qualifications, warnings and limitations enunciated in respect of s.51(i) and the unanimous

and ready acceptance of the power under s.51(xx) to control, to a degree, the trade of s.51(xx) corporations, is striking. It perhaps points to the conclusion that intellectual conviction regarding the construction of s.51(i) and a view as to proper judicial method was what produced the court's attitude rather than any notion of what sort of federal system the Constitution prescribed. (*The High Court and the Constitution*, 2nd ed., 1981:71-2; emphasis added)

Although I believe other factors also influenced the contrast noted by Professor Zines, there is, with respect, much truth in his observation.

Returning to the question noted earlier, is Australian culture devoid of a moral dimension?

Australian governments hold elections, which they even lose occasionally, whereupon they vacate office, and civil liberties are generally respected, especially by the courts. Is all this attributable to mere expediency? If Australian citizens can rest more secure in their rights and liberties than citizens of Ethiopia, the USSR or Chile, for example, does this say nothing whatever about the moral foundations of Australian life?

One may concede that many political decisions appear to be based upon mere expediency, but when was it ever different? And this hardly establishes either utilitarianism or a general moral bankruptcy on the fundamental issues of Australian public life. I doubt also whether public opinion is as opposed to limitations on government as Dr O'Hair suggests — if it were, would referendums to increase governmental powers fail so consistently, and would there be such widespread support for viceregal reserve powers to check arbitrary governments?

It follows that I am unpersuaded by Dr O'Hair's reasons for advocating a radical revision of Australia's constitutional arrangements (pp.305-6). While there may, indeed, be cogent arguments for converting the federal system into a unitary one, whether or not in combination with Swiss-style referendum procedures, those changes ought to be considered on their merits, and not proposed for ulterior purposes. But the paper does not even begin to debate their merits.

However, even if Dr O'Hair's premises be accepted, I do not see how the proposed new structure would overcome the so-called 'utilitarianism' in Australian culture.

## DISCUSSION

**Robin O'Hair:** As lawyers, we must be practical. That is something, whether one agrees with his jurisprudence or not, with which Julius Stone would surely have agreed. Practically speaking today, if one is engaged in business activity, or indeed any other form of activity, the constitutional limits to the federal government and the States are in decline. They are now almost non-existent.

Mr Justice Murphy may have had a strong attachment to section 80 and section 116, and Mr Justice Evatt may have had a strong attachment to section 80. Nevertheless, section 80, which apparently guarantees jury trial, is still interpreted to mean that it does not. Section 116, which bears on religious freedom, has not received a wide construction, notwithstanding Mr Justice Murphy's dissents. Section 92, which guarantees freedom of interstate trade, has proved ineffective to guarantee freedom of communication in relation to air waves and the electronic media. This was notwithstanding a powerful dissent from Mr Justice Murphy.

In the result opposition to government policy on the foundation of rights-based arguments is not likely to be successful in the courts. Actions speak louder than words. It would be an error for us to delude ourselves into thinking the courts will provide substantive protection to the individual against government actions. While words are no doubt soothing, one is reminded of Mr Justice Holmes's statement that soothing words eventually must be stripped away and the reality bared. The reality His Honour sought to bare is very similar to the reality that exists in Australia today, namely that private property could be regulated for public purposes, to virtually any extent.

I think that George Winterton missed the nature of my argument on utilitarianism. Utilitarianism is a philosophy that puts everything up for grabs. It is a philosophy that has no givens, other than a ceaseless search for the greatest good of the greatest number. I do not equate utilitarianism with expediency, although utilitarianism has proved an extremely effective means of apologising for expediency. Nevertheless, while Mr Winterton seems to argue that there may be some principle of right within a utilitarian culture, the only person who has presented an argument that has gained a strong support founded on the concept of legal rights within a utilitarian system is Ronald Dworkin, and I

believe that Stephen Macedo's criticisms of Ronald Dworkin's system are dispositive.

In a paper the length of mine it is not possible to go over every decision, but after writing a book of 900 pages Professor Lane came to effectively the same conclusion — but plainly not as trenchantly expressed. I really do not think there is much point in trying to argue that there are any substantive constitutional limits left unless one, like Dr Pangloss, wishes to imagine one is in the best of all possible worlds.

George Winterton suggests that the High Court has been enamoured of the consistent application of principles of constitutional interpretation. Interestingly, within that concept, it is very hard to see how the approach to the concept of substance and form is consistently reflected in cases on excise and in cases on constitutional power. Indeed, it does seem that 'heads the States lose, tails the Commonwealth wins'. That may be too simplistic in interpretation, but the results do speak volumes.

The reasons Australians can rest more secure in their rights and liberties than people in communist or fascist countries rests with community opinion. Where that opinion is solid for individual rights, then those rights will be preserved within the framework of a utilitarian system. I have never suggested that there are no moral foundations to Australian life; I have merely suggested that there are no moral foundations to Australian politics. Interestingly, Winterton's equation, admittedly unconscious, of Australian life and Australian politics bears out my point. Today there seems to be no area of human endeavour that is not regarded in the realm of politics, and indeed, that is the essence of the rejection of a rights-based culture and the acceptance of a utilitarian one.

Winterton seems to imply that it is up to me to prove Australian politics does not rest on moral foundations. My proposition, my hypothesis, is that it does not. I have indicated instances in my paper that are consistent with this position. As George is no doubt aware, the modern philosophy of science requires others to falsify my point; I am yet to be convinced that they have done so.

No doubt politics has always been based on expediency. One does not doubt that. However, there always used to be limits, within liberal constitutional theory, to the computing principle — utilitarianism — in politics. Today, a realistic assessment means that we should appreciate that there are no limits of a legal nature.

Assuredly, introducing the referendum is not going to override that utilitarian bias, but it will accommodate it. It will ensure that the utilitarian calculations proffered are genuine ones and not hypostatized ones fashioned for the occasion as a smoke-screen for something else. If we would have utilitarianism, then it is essential that the calculations be subjected to the individual voter, not merely a means by which third

persons smuggle their preferences into public policy under the guise of the endorsement of the will of the people. Perhaps George's suggestions about the defeat of referendums indicate that this is going on. That is a question requiring of much more research.

The only point I would wish to stress, in conclusion, is that the responsibility for the erosion of State power and therefore of the restraints on power that that implies lies squarely with the federal government, and in particular with the High Court. The States do not have the initiative in the structure of federal legislation. They do not appoint persons to any federal senate. My suggestion of allowing the States to cause referendums to be held relative to federal statutes would mean that the competing institutions of power within our society would be able to discipline each other. That would be an enormous step forward. It would mean that we had accepted some principle of decentralisation as to initiative within a utilitarian culture.

My suggestions are directed at making utilitarianism honest. I would like to think — I once would have thought — that we could do better; but unfortunately, within Australia, deep attachments to individual liberties and rights are rare and uncommon. Sir Victor Windeyer's comments on section 92 surprise me, not because they in some way limit section 92, but because of the hostility to the common law concept of individual liberty and individual rights they entail. They bear a distinctly Holmesian streak. They reek of Hobbes. It was Frank Knight who said that a social optimum may be a ship going down with a captain on the deck with the funnels falling in. Unfortunately such is the prospect for constitutionalism in Australia.

**Martin Krygier (University of New South Wales):** Robin O'Hair is among those who argue that the rule of law has been ebbing away in modern times. What seems to be happening is that the nature of law is being changed systematically in welfare states. There is more and more goal-oriented, purposive, bureaucratic law as opposed to law conceived as stable, non-goal-oriented restraints on power. That this is happening, and happening in all modern states, is uncontroversial. But it has never been demonstrated that this represents some kind of crisis for the rule of law, or indicates that the law is any less of an overall restraint on power in societies — like Australia — where law counts as a check and not merely an instrument of power. In relation to Australia, such claims are absurd. Recall the change of government in Australia in 1975. The whole crisis was transacted in the most extraordinarily legalistic terms, terms which are incomprehensible in many other parts of the world. That's a testimony (and, I think, a tribute) to the fact, ignored by those who argue that we live in a highly utilitarian, non-rights-based culture, that we have one of the most law-based and law-respecting cultures in the world.

**O'Hair:** My argument, which I think has not been assailed, is that the courts do not provide protection from government power. That's the practical reality as far as the man in the street is concerned. At the federal level, the community is prepared to wear an awful lot, because the questions are of a sort that don't immediately present themselves as issues of principle, but (as with the Tasmanian dam) as utilitarian issues. In that context only lawyers talk in terms of rights.

The political reality in Australia today (which in the end determines the kind of constitution we have) remains highly utilitarian. People weigh up and balance any given issue, and if they think the balance is in their favour they support it. That's not completely incompatible with the idea of individual rights, but in a utilitarian culture all rights are vulnerable to majority decision.

**Hugh Collins (Australian National University):** It seems to me that federalism has worked out in Australia in ways quite different from its classical formulation. If one were interested in limited government (a less pejorative term than 'small government') would one any longer support our federal system?

**O'Hair:** On paper, probably not. But federalism introduces an incredible legal complexity into the system. This slows down the speed with which government can respond to regulatory temptations and in this sense it promotes a dynamic economy. On the other hand, given that so many of the constitutional constraints are no longer legally enforced, federalism may no longer be a device for limited government.

# CONCLUDING DISCUSSION

led by

*Geoffrey Brennan*

A prayer that occurs to me in this context goes as follows: 'Almighty God, give me the energy to improve those things that can be changed; the patience to endure those things that cannot be changed; and the wit to tell the difference'. A corresponding biblical text is Jeremiah 8:11, which reads: 'For they have healed the hurt of the daughter of my people slightly, saying, Peace, peace; when there is no peace'. This Jeremiaic sentiment captures my own feelings about some of the things we have been saying, because we have made both the diagnosis of the problem and the solutions to it seem enormously easy. The sentiment comes in several versions. A political scientist's version runs 'Whoever you vote for, a politician is always elected'. An economist's version states that 'there's no such thing as a free lunch'. Jeremiah, the political scientist, and the economist are all saying more or less the same thing.

Assuming that we think there's a 'problem' about the size of government, do we see ourselves as *part* of the ideological battle (or a battle of interests), or are we *above* it? Most economists try to be above the battle and claim to be making authoritative, objective judgments to the effect that efficiency requires small government. They believe, that is, that they are doing more than just expressing personal preferences for smaller government. However, I don't believe that the language of welfare economics really allows economists to escape from the arena of the ideological battle. The crucial normative test here, as I said in my paper, is being able to show that smaller government leaves *everyone* better off. But the fact is that tariff cuts, abolishing taxi medallions, deregulation, etc. do hurt people. A flat tax lowers the tax burden for some but raises it for others. It could be that the gains outweigh the losses. But it doesn't follow that compensation will

necessarily be paid to the losers. We have to be able to rise above the conflict of interests between winners and losers to be sure that smaller government is indeed a good thing. It's not obvious that we've done anything more in this conference than to express our own preferences on the issue of government size. We haven't shown that government is too large, in the sense that a reduction in its size would leave everyone better off. Suppose we could, by reducing government, make some people better off and no one worse off. Why then wouldn't a political party do it? Universal net gains, after all, are a free lunch. But if economists are right in saying that free lunches don't exist, this must mean that there are no universal gains from smaller government.

Orthodox public choice theory claims that the redistributions involved in political interventions are the central elements in explaining their existence. That is, it isn't incidental that taxi medallions help some people and harm others; on the contrary, that's precisely why they exist. Rational politicians put together packages of policies (including redistributive interventions) that maximise their chances of election. The speaker who has come closest to recognising the nature of the problem is Ian Harper.

I believe that we are necessarily both in and above the ideological debate. We can't pretend that we don't bring to the subject our own interests and ideological preferences. That said, we should retain a strong sense of the distinction between our two roles. A prime test of this is whether our ultimate commitment lies in small government or somewhere else. For my own part, I think of myself as committed not so much to small government as to good government: that is, government that is more rather than less responsible to the people, more rather than less overt, and more rather than less aware of what politicians are and are not likely to be able to deliver. Whether or not such good government turned out to be small government would be a contingent matter, something that emerged from the appropriate political processes. If we are right, then government will indeed be small. But we have to accept the logical possibility that we may be wrong. Otherwise, our commitments are not to good government but to small government, and while we may believe that these are one and the same thing, it seems to me that this has yet to be established.

**Edwin Brooks (Riverina-Murray Institute of Higher Education):** I agree that the case for small government may not appeal to everyone, and that it may be based too much on anecdote. But I find quite remarkable the argument that unless we can establish that there are universal benefits for smaller government, then we are precluded from making the case without impugning our integrity. There can be arguments, as in the criminal law, that harm some people but benefit most. The use of the pejorative term 'ideological' here may be

very damaging. We are entitled to put forward theoretical models that may establish, presumably on sound evidence, that a certain course of action is desirable. But to insist that it must bring universal benefits in the pluralistic society that we have seems to me to build an Aunt Sally.

**Brennan:** In stressing consensus, I'm simply noting what efficiency means. There is a crucial connection between consensus (or unanimity) on the one hand, and the Pareto criterion on the other, from which the economists' notion of efficiency is derived.

**Cliff Walsh (University of Adelaide):** Professor Brennan is issuing a warning with which I agree. We may be deceiving ourselves if we think we are being purely objective. Perhaps the problems are harder than we have been assuming them to be. On the other hand, Professor Brennan seems to me to come dangerously close to arguing that they are too hard, especially in his treatment of the issue of compensation. It isn't clear to me that, if such compensation could in fact be paid, then someone would have done it. Under a constitution that provides for majority rule, does it make much sense to demand that analysis be undertaken to establish whether compensation could be paid? In principle it may well be possible to show that everyone would be made substantially better off by reductions in some public sector activities, especially if the dynamic effects are taken into account. Practicable packages of reforms could be constructed that included rough compensation for short-term costs.

The emphasis on good government elevates the discussion to the constitutional level. But is it really possible to effect constitutional reforms from which there are no losers? This seems to lead to an infinite regress: if we can't agree on political outcomes, we go to the constitutional level; if we can't agree on constitutional reforms, then we go to the super-constitutional level; and so on. Professor Brennan thus ends up articulating a fundamentally conservative thesis.

**Brennan:** Assume that majority rule is optimal, and that anything that emerges from it is acceptable. But that means accepting big government if that's what the majority want. It doesn't provide economists with the trump card they've wanted to bring to bear on these matters.

**Wolfgang Kasper (University of New South Wales):** We shouldn't let Jeremiah Brennan get away with the meek and pessimistic tone which I think I detected in his speech. (At this conference I've learned that public choice theorists are rather pessimistic people.) Can't we assert some of our insights with more fire and brimstone? It is, after all, fair to say that smaller government brings more economic growth.

The OECD figures don't always show this, because welfare states bloat their statistics by counting the output of the public sector and community services as production. But the figures for the marketed product show that where there have been big increases in regulation and the size of government, economic growth has tended to slow down 10 or 15 years later.

It seems to me that, as economist-preachers, we need to distil the results of our research into simple propositions, so that people from various walks of life can test them and find out for themselves whether they are plausible. We have to propagate simple messages, basic truths that can be defended. This sometimes conflicts with a professional wish to be meek and agnostic, but economists should guard against becoming lost in a maze of second- and third-order problems which a functioning market will solve anyway.

**Brennan:** Public choice theorists are indeed a little pessimistic. But that's because they faithfully reflect their origins as economists: specialists in 'the dismal science'. We begin with the assumption that the world is as it is for substantial reasons. We believe in the relevance of constraints: not everything is possible. Even if it were true that we were in an n-person prisoners' dilemma resulting in an overexpanded government, it wouldn't necessarily follow that there was a way out of it. That's an aspect of our dismal situation.

On your conception of the economist as preacher, as the simplifier of ideas, surely the particular responsibility of the academic economist or political scientist is to get his arguments *right*, however complicated and inconclusive they might be. The alternative is a mindless activism, which I find less attractive. The academic who assumes the role of preacher should do so with some show of reluctance.

**Ray Evans (Western Mining Corporation):** We are in the midst of what Professor Brennan calls an 'ideological' battle. But a sense of moral outrage has more to do with it than any other factor. People are outraged at being so put upon by bureaucrats and politicians. Why should exporters, farmers in particular, have to pay 20 per cent of their export income to keep protected industries in luxury? Professor Brennan reminds me of those ecclesiastics of the early 16th century who tried to dampen down the Lutheran fires. Look what happened to them!

**Brennan:** No one point of view has a monopoly of moral indignation. Plenty of people are full of indignation about all kinds of issues. Moral passions are a very bad guide to policy.

**Patrick Minford (University of Liverpool):** Professor Brennan has indeed been provocative. When he wonders why the benefits of

smaller government (if there are any) have not been realised, he reminds me of the story about the Chicago economist who was told there was a ten-dollar note on the pavement. He replied that it wasn't there, because if it were, someone would have picked it up.

The point about the arguments showing that smaller government is more efficient is that they indicate Pareto-optimal political opportunities. But democratic majorities might well decide not to buy out the losers because they don't see why they should compensate those who have been making illegitimate gains from big government. This may be why the potential losers from smaller government hold up the process and frustrate democratic majorities. But what economists, think-tanks, those of us in the ideas business are doing is to provide information to politicians and voters about potentially vote-winning policies, which they might otherwise have missed. This is part of the discovery process in a democracy.

**Peter Swan (Australian Graduate School of Management):** I don't agree with Professor Brennan when he implies that the gainers from smaller government should not only be able to compensate the losers but are actually morally obliged to do so. Suppose the government legalised mugging, and mugging activity expanded. Then at some later stage it is proposed to restore the law against mugging. No doubt the non-muggers could compensate the muggers, but they would surely be under no moral obligation to do so.

It's no different with taxi medallions. In the past taxi-owners have lobbied to have the number of medallions limited so that they can gain large monopoly rents. If we increased the number of medallions, we no doubt could compensate the losers. Professor Brennan would presumably argue that it would be unfair not to compensate the existing owners of the medallions, those who've paid about \$90 000 for them. But my answer to that is that taxi-owners have accepted the risk that the law will be changed in such a way as to reduce the value of their medallions, and that their returns include an adequate compensation for that risk. We may rightly, therefore, consider changing the law without compensating the losers.

**Brennan:** If the argument for small government is about justice, or rights, or the legitimacy of certain kinds of government activity, then let's spell it out. But it won't be an argument about efficiency gains and losses. Instead it will assert that small government is desirable because taxation is theft, or something similar.

Let's recall what the Pareto criterion of efficiency is. It says that a policy is desirable if and only if everyone is made better off, and no one is made worse off. In other words, the winners must be able to compensate the losers. Those are hard policies to find. Of course it's

easy for majorities to conclude that they'd be better off if they abolished interventions such as taxi medallions. But if it is not possible to compensate the losers, then the case for such abolition cannot be made in terms of efficiency.

Peter Swan's argument that the price of a taxi medallion is reduced by the risk of legal change is a reasonable one. But I don't think it's a knockdown argument. Suppose you choose to buy a house in an area with a high incidence of mugging. That circumstance will lower the value of the land you buy. Then you get mugged in the street outside your house, you apprehend the mugger, and ring the police. The police refuse to take action, and advise you to release the mugger, arguing that you've already been compensated for the mugging by the lower price you paid for your house. Would you accept that argument?

To repeat: if we want to argue for smaller government in terms of justice or rights, then these arguments need to be explicitly laid out. In this conference we've heard a lot of arguments for deregulation and so on expressed in terms of generalised efficiency and cost-benefit calculations. But these aren't going to do the job that is being demanded of them.





## Index

- Australian Bureau of Statistics (ABS): its definition of the public sector, 11-12, 28; employment in, 42, 138
- Austria, 32, 153
- Austrian economics, 4, 70, 173, 232
- Belgium, 32
- Bentham, Jeremy, 49, 50, 56, 64-5, 288, 289
- Bill of rights, 292
- Borrowing requirement, 15-17, 71, 127, 165, 193-4, 232; and macro controls, 239, 251, 255, 256, 280, 282
- Buchanan, James, 4, 106, 312, 316
- Bureaucracy, 107, 270
- Burke, Edmund, 287
- Business Regulation Review Unit (BRRU), 42, 135, 138, 139, 154
- Canada, 29-30, 32, 42, 204, 300
- Chicago economics, 342-3
- Churning, 6, 118, 120, 13
- Commonwealth government: its outlays, revenues and borrowing requirement, 14-17, 64, 108-10, 121, 251, 262; its non-budget outlays, 19-20, 108-10; employment in, 25-6, 40-1, 138, 262, 268; its tax expenditures, 32-9, 43; its regulations, 39-42
- Compensation, 76-7, 120, 147, 278, 298, 339-40, 341, 343-4
- Conciliation and Arbitration Commission, 151, 171, 178
- Constitution, Australian: and federalism, 52, 291-3, 332, 335, 336, 337; and limits on government, 287-306, 331-7; and separation of powers, 290-3, 332; and interstate commerce, 295-6, 332, 334; and taxation, 297; and property, 298-9; and medical practice, 299-300; and Senate, 300-1; and causes of failure, 301-4; and referendum, 333, 335-6
- Sections referred to:
- s. 41, 294
  - s. 51(i), 332-3
  - s. 51(xx), 332-3
  - s. 51(xxxi), 295, 298-9
  - s. 51(xxiiiA), 295, 299-300
  - s. 80, 332, 334
  - s. 90, 295, 297
  - s. 92, 295-6, 302, 332, 334, 336

## *Restraining Leviathan*

- s. 99, 294, 332
- s. 80, 294-5
- s. 100, 294
- s. 116, 294, 332, 334
- s. 117, 294
- See also* Federal financial relations
- Constitutional limits on government, 123, 262, 289, 287-306, 311-30, 331, 341; reinforced majorities, 316; uniform tax and expenditure, 316; decentralised tax and expenditure decisions, 316; longer terms of political office, 317; balanced budget, 317, 325; tax revenue (share) limits, 319, 320-1; tax base limits, 319, 322-5, 326; tax rate limits, 319, 325-30; maximum rate limits, 325-6; rate structure limits, 326-30; limits on tax expenditures, 325; limits on regulations, 325
- Contestable markets, 70, 76, 130, 141, 223, 226-7, 230-1, 232
- Contracting out, 268, 278
- Cross-subsidies, 61, 110, 143, 145-6, 167, 197, 220
- Denmark, 29-30, 32, 254
- Deregulation: in Australia, 40, 52, 64-5, 164-7, 177-8, 214, 232; in United Kingdom, 89, 94-5, 130, 227, 23; in United States, 163-4, 177-8; guide to promotion of, 168-71; and privatisation, 203, 206, 208, 223, 227, 230, 231
- Dixon, Chief Justice Sir Owen, 289-90, 297, 299, 303-4
- Downs, Anthony, 106
- Dworkin, Ronald, 334-5
- Economic growth, 11, 101-2, 127, 153, 173-4, 246, 264, 341-2
- Efficiency, 3, 69, 82-8, 102, 105, 108, 113, 119, 123, 137, 143, 186, 208, 216-21, 230, 232, 233; productive vs allocative, 204-6, 209, 223, 227, 23; vs effectiveness, 280; and Pareto-optimality, 311, 339-44
- Employment: in Australian public sector, 20-6, 29-32, 42, 262, 268, 270, 272; international comparisons, 31-2, 42; regulatory, 40-1, 42, 138
- Equity, 3, 5, 102, 107, 108, 113, 118-20, 137, 145-7, 149, 175, 178, 326, 343-4
- Expenditure Review Committee, 34
- Externalities, 5, 113, 144, 147, 210
- Federal financial relations, 14, 110, 111, 121-2, 132, 291-2, 297
- Federalism. *See* Constitution, Australian
- Ferguson, Adam, 288
- Finland, 32
- France, 29-30, 32, 204
- Friedman, Milton, 5, 149, 176, 289
- Galbraith, Kenneth, 106
- Germany, 29-30, 32, 204, 254
- Gramm-Rudman law, 237, 242-4, 283
- Gray, John, 288-9
- Hancock, Sir Keith, 49
- Hayek, Friedrich von, 4, 288, 289, 293
- Hobbes, Thomas, 55, 62, 336
- Hume, David, 288

- Ideas vs interests, 7, 168, 169, 170, 176, 178
- Industries Assistance Commission (IAC), 140
- International comparisons of public sector size and growth, 26-32, 42-3, 58, 62
- Italy, 32, 204
- Japan, 29-30, 32, 58, 72, 153, 204, 220, 221, 226, 254
- Keating, Paul, 53
- Keynes, John Maynard, 4, 171
- Labour market regulations, 150-53, 170-1, 174, 178
- Laski, Harold, 92
- Liberal/libertarian ideology, 52, 64-5
- Loans and loan guarantees, 32, 103
- Loans Council, 132
- Local governments: their outlays, revenues and borrowing requirement, 14-17, 109; employment in, 25-6, 42, 138; their regulations, 42, 43
- Macro controls on fiscal aggregates, 123, 237-58, 283, 318-19; arguments for, 238-40; criteria for, 240-1; in USA, 241-4, 257-8, 283; in UK, 244-51, 254, 282; in Australia, 251-4, 255-6, 262, 277-8; in other countries, 254
- Malaysia, 204
- Mandeville, Bernard, 288, 289
- Market failure, 4, 69-70, 113, 148, 210-11
- Marshall, Alfred, 70, 72, 79
- Meade, James, 3-4, 5, 6
- Medium Term Financial Strategy (UK), 194, 238, 249-51, 277, 282
- Micro controls on public expenditure, 122-3, 261-75, 278, 280-1, 282
- Monopoly: natural, 3, 75-6, 82-3, 113, 141, 175, 177, 210, 226-7; private vs public, 70, 75, 115, 130, 198-9, 230-1, 234, 251; its social costs, 72-3, 76-7, 115, 175, 196, 209, 231; and regulation, 130, 138, 50, 167, 175, 177, 206, 210; labour monopolies, 150, 178
- Negative Income Tax, 86-8, 119, 139
- Neo-classical economics, 173
- Netherlands, 32
- Niskanen, William, 107, 115
- Norway, 32
- Nozick, Robert, 64-5, 288
- Olson, Mancur, 4
- Organisation for Economic Co-operation and Development (OECD): its definition of the public sector, 12, 26, 28, 342
- Pareto-optimality, 311, 339-44
- Policy review, termination, innovation, and succession, 122, 261-75, 278, 280-1, 282
- Popper, Sir Karl, 288
- Portugal, 32
- Poverty alleviation, 5, 82, 118-19
- Poverty trap, 81, 90, 131
- Privatisation: in Australia, 52-5, 62, 183, 187-91, 209-34; in the United Kingdom, 53-4, 77, 88-9, 93-5, 130, 182-3, 183-5, 187, 191-3, 195, 196-7, 203-4, 206-9, 231, 234; in other countries, 204; the cure for waste in public production, 75-7, 82-4, 88, 115, 121;

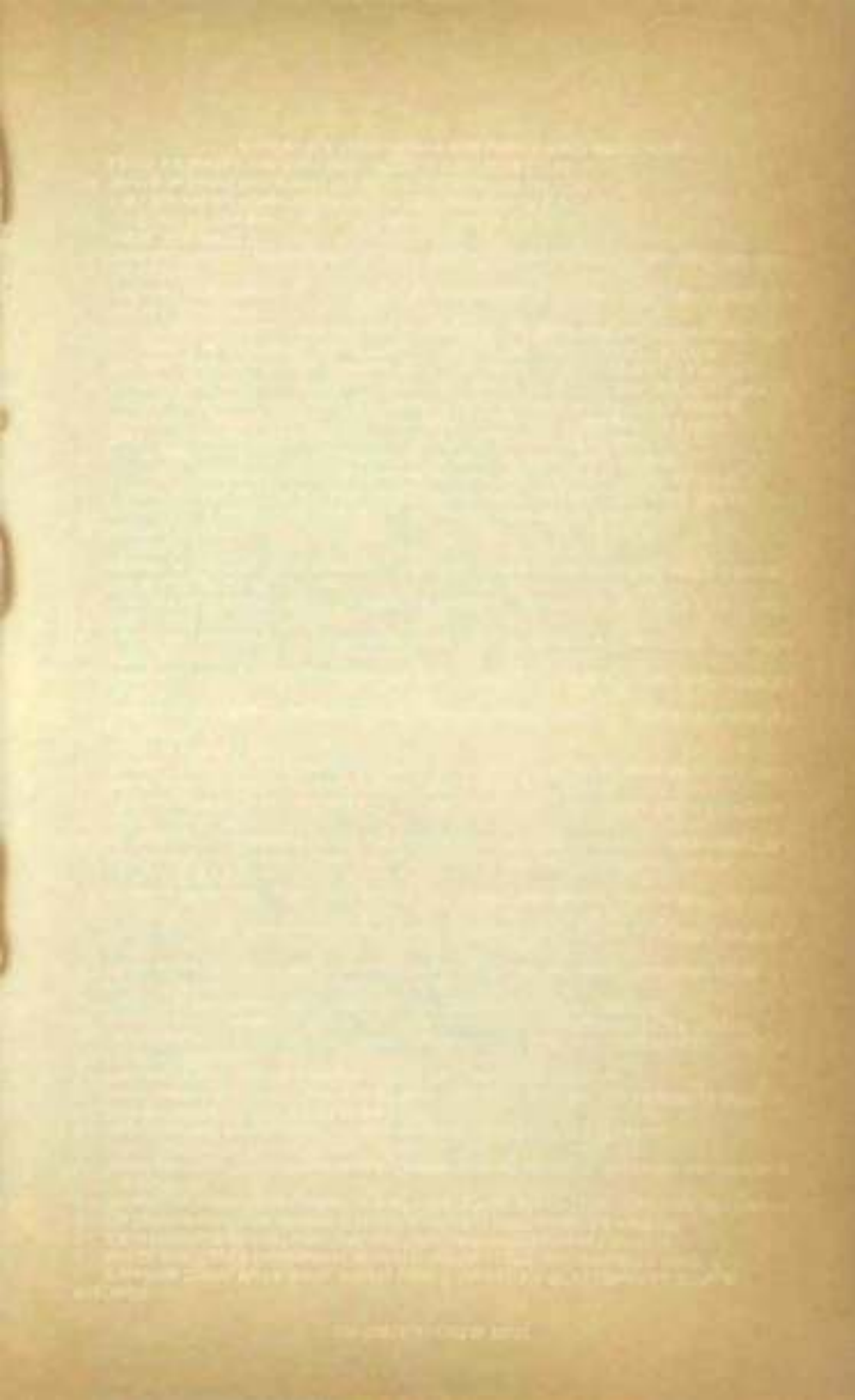
## *Restraining Leviathan*

- priorities, 186-91, 221-3; and influence of senior management, 130, 196, 208-9, 233-4; financial implications, 193-6, 197-8, 208-9, 249-50, 277; and 'popular capitalism', 195-6, 209, 232; methods of, 203-4, 223; and deregulation, 203, 206, 209, 223, 230, 231, 232; economic case for, 204-6, 232-3, 234; and productive vs allocative efficiency, 204-5, 223, 227, 230-1; conflicting objectives of, 208-9; measurement of gains and losses, 230-3; political aspects, 232-3
- Programme budgeting, 265
- Property rights, 6, 135, 144-5, 298-9, 334
- Public choice theory, 4-5, 7, 52, 70, 106-8, 127, 178, 340, 341-2
- Public consumption, 71, 77-81, 84-7, 88, 103, 104, 109, 110-12
- Public expenditure:
  - international comparisons of, 7, 26-32, 42-3, 58, 62, 238, 261-2; its effect on economic growth, 11, 101-2, 127, 341-2; in Australia, 13-20, 42-3, 58, 61, 99-124, 127-8, 250, 255, 262; its growth vs its composition, 17-19, 59; its three aspects, 70-1; why 'too big', 101-2; over- vs under-expansion of, 102, 105-8; exhaustive vs non-exhaustive, 110-12; principles for evaluating, 112-20; factors limiting flexibility in, 279-80; why increased by broad-based taxes, 323-4. *See also* Constitutional limits on government; Macro controls on fiscal aggregates; Micro controls on public expenditure
- Public Expenditure Survey (UK), 244-6
- Public goods, 3, 59-60, 77, 78, 82, 83-4, 88, 91, 106, 113, 311, 316
- Public production, 70, 71-7, 82-4, 88, 114
- Public purchase. *See* Public consumption
- Public sector: defined by ABS, 11-12, 28, and by OECD, 12, 26, 28
- Public trading enterprises, 13, 19, 28, 70; employment in, 21, 24; cross-subsidies in, 61, 143, 145-6, 167, 197; the major enterprises, 188-91; their relative inefficiency, 197, 204-6, 207-8, 209-10, 216-21, 238, 232, 234; effect on revenues, 198; and management incentive structures, 205-7, 207, 211-16; and natural monopolies, 210-11, 226-7; privatisation of, *see* Privatisation
- Rational expectations theory, 69-70
- Rawls, John, 5
- Regulations, 13, 37-42, 61, 116; their costs, 39, 138-40, 141, 143, 149, 173-4; vertical (economic) vs horizontal (social), 39-40, 137-8; regulatory employment, 40-2, 43, 138; and privatised industries, 89, 130; in public choice theory, 107, 159, 178; and monopolies, 130, 138, 141-2, 150, 175, 177, 206, 210; their scope, 135-8; definitions of, 135-6; their benefits, 140-50.

- 174; and equity, 145-7, 149, 175; and labour market, 150-3, 170-1, 174, 178; retard economic growth, 153-4, 173, 342; various theories of, 159-60, 165; private interest theory of, 159-61, 164, 165, 168-9, 206; encourage development of close substitutes, 162-3, 168, and hence promote deregulation, 163-5, 168 — example, the Australian financial system, 164-6, 178; and telecommunications, 166-7, 177, 178; and constitutional limits, 325. *See also* Deregulation.
- Rights, 292, 304, 331, 333, 334-7, 343-4
- Rule of law, 6, 289, 291, 304, 331, 336
- Sawer, Geoffrey, 293
- Schumpeter, Joseph, 161-2, 168, 170, 175, 304-5
- Singapore, 204
- Smith, Adam, 7, 173, 178, 288
- Spain, 29-30, 153
- Special interests, 4, 7, 76, 106-7, 127, 141, 159, 160-1, 168, 170, 171, 175-6, 231, 242, 267, 268, 314-16
- State governments: their outlays, revenues and borrowing requirement, 14-17, 108-10, 121, 262; their non-budget outlays, 19-20; employment in, 25-6, 42, 43, 138, 262; their regulations, 42, 43; and income tax power, 123; and privatisation, 183-4, 189-91
- Stigler, George, 107, 135, 159-60, 161, 174
- Stretton, Hugh, 56
- Subsidies, 61-2, 72-5, 79, 84-7, 103, 104, 111, 116, 117, 118, 144, 145, 227, 320-1. *See also* Cross-subsidies
- Sunset legislation, 282
- Sweden, 29-30, 32, 153
- Switzerland, 7, 333
- Takeovers, 141, 145, 205, 235
- Tariffs, 61-2, 72-5, 140, 143, 145, 174, 176, 297
- Taxation, 6, 14; income vs substitution effects of, 59; proportional vs progressive, 60, 130-1, 283, 339; average vs marginal rates of income tax, 60, 128-9; different kinds of, 71, 81; implicit, 79; and poverty and unemployment traps, 81-2, 86, 87, 90-1, 119-20, 131-2; and indexation, 123, 128, 283, 318-19; and fiscal drag, 127-9; and equity, 147, 326; and macro controls, 239, 251-2, 254, 255, 256, 277, 283; its expansion, 297; broad-based, 323-4, 326. *See also* Constitutional limits on government; Federal financial relations; Negative Income Tax
- Tax expenditures, 13, 32-9, 43, 61, 103, 104, 277, 280, 321, 325
- Telecom Australia, 143, 166-7, 175, 177, 178, 183, 189-90, 230, 234
- Thailand, 204
- Transfer payments, 13, 15, 17, 21, 29, 31, 59, 87-8, 103, 108-9, 111, 118, 119, 130-1, 146-7, 175
- Transport: and privatisation, 209-27; ownership structures and competition in, 211-16; and efficiency, 216-27
- Trilogy, 12, 99, 123, 238, 251-4, 255, 262, 277-8, 280

*Restraining Leviathan*

- Tallock, Gordon, 4, 7, 106,  
115, 173, 316
- Two-Airline Policy, 139, 170,  
177, 188, 210-11, 214
- Unemployment trap, 81, 87, 90,  
120, 131-2
- United Kingdom, 7, 29, 32, 53-  
4, 69, 72, 82, 88-91, 130,  
132, 153, 169, 181-3, 184-  
5, 186-8, 191-8, 203-4,  
206-9, 231, 232, 233, 234,  
237, 238, 244-51, 254,  
261, 263, 277, 282
- United States of America, 7, 29,  
32, 42, 69, 138, 139, 163-  
4, 168-9, 177, 178, 210,  
237, 241-4, 257-8, 261-2,  
270, 282
- User charges, 14, 64, 102, 110,  
116, 117, 119, 120, 121,  
185, 263, 281, 324
- Utilitarianism: and character of  
Australian politics, 49-52,  
56, 64-5, 287-90, 302-3,  
331-3, 334-7; and moral  
limits on politics, 288,  
331, 333, 334-6
- Virginia School, 4-5
- Wilenski, Peter, 53



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Small Government in Practice

Edited by Michael James

In recent years politicians in all major Australian parties have come to accept that government can best help promote the goals of economic growth, social justice, and individual freedom by reducing the scale of its interventions. Australia's economic difficulties have pushed to the top of the agenda the need to cut public spending and to revitalise the economy through deregulation and privatisation. But although governments do sometimes succeed in terminating spending programs and abolishing regulations, evidence from Australia and other Western countries suggests that public sectors are still expanding, however slowly. The nature and causes of 'big government' are still far from completely clear to us.

This collection (based on the proceedings of a conference held by the Centre for Independent Studies in November 1986) seeks to increase our understanding of the scope and opportunities we have for making substantial and permanent reductions in the size of Australia's public sector. Patrick Minford and Cliff Walsh explore ways of eliminating waste in public sector spending. Alan Moran provides an overview of the costs and benefits of business regulations, and Ian Harper suggests ways in which the special interests protected by them can be persuaded to support deregulation. The relevance of privatisation to Australia is discussed by Chris Trengove, and Keith Trace looks at the prospects for privatisation in the transport sector. Jon Craig and Scott Prasser examine long-term controls on public spending, such as the Trilogy commitments of the Hawke Government of 1984 - 87. The role of the Constitution in establishing constraints on the size of government, and its potential for being reformed in that direction, are discussed by Robin O'Hair and Geoffrey Brennan. The collection begins with an attempt by Peter Saunders to measure the size and growth of Australia's public sector; this is followed by Hugh Collins's discussion of Australian attitudes towards the state. All the papers are commented on by qualified discussants.

The political and bureaucratic obstacles to significant reductions in the scale of government intervention are formidable. But they must be overcome if Australia is to have a chance of halting its steady decline in the world prosperity league, let alone recovering its erstwhile pre-eminence there.

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