NEW ZEALAND
BusinessROUNDTABLE
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Public Policy

An Introduction

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New Zealand Business Roundtable
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The New Zealand Business Roundtable is an organisation comprising primarily chief executives of major New Zealand businesses. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

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If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable government to control the governed; and in the next place oblige it to control itself.

James Madison, American statesman, 1788

FOREWORD

This paper is intended as an introduction to the topic of public policy. Contributing to the development of good public policies for New Zealand is central to the mission of the New Zealand Business Roundtable.

Good institutions and policies typically dominate other factors in determining the economic performance of countries. Improvements to institutions and policies explain much of the prosperity of Western nations since the Industrial Revolution and the rise of countries such as China and India today.

New Zealand's earlier prosperity owed much to an environment of general economic freedom and a generally observed rule of law. Its economic performance deteriorated for much of the twentieth century with the adoption of policies that restricted economic freedoms, and has improved in the past two decades as many of those mistakes were corrected.

What does public policy seek to achieve? A broadly accepted answer is that it seeks to maximise what people value. Just as a business strategy for most firms aims to maximise the value of the investments owners make in them, good public policy aims to maximise the scope for human flourishing.

What people value is by no means limited to economic success, even though improving material standards of living – and particularly the alleviation of hardship – are important goals. Indeed the value that most people probably put most weight on is freedom. But clearly they also value fairness, justice, environmental quality and other social goals.

The tools of public policy assist in deciding how best to pursue those goals. They also help to assess trade-offs between them when they are in conflict. It is important for policy makers to know how much of something that people value has to be given up to achieve some other goal. It is also important that analytical rigour and empirical evidence are employed in making policy decisions.

An understanding of good business practice is not to be confused with an understanding of good public policy practice. The knowledge and skill base required in each area differ. Public policies that might benefit a particular firm may not be in the interests of the wider economy and society. Nevertheless, the business sector at large has an interest in a healthy, growing economy and a cohesive society, and in the public policies that promote them. Representative business organisations concerned with public policy exist to evaluate public policy issues professionally and can take a broader national interest perspective.

Although there can be legitimate differences of view on public policy issues, and understanding of good practice continues to evolve, economic and other social research provides considerable guidance on what constitutes good public policy. Too often outdated ideas, ignorance of empirical evidence, or demonstrably flawed analysis feature in public debates. The aim of this paper is to help policy makers, business people, the media and others with an interest in public policy understand how it can best enable New Zealanders to achieve what they most value.

Rob McLeod
Chairman
New Zealand Business Roundtable

1
INTRODUCTION

Public policy matters. Ample economic research shows that it is not the size of the population, the level of the natural resources or the geographic location of a country that determines its long-run economic performance. Rather, it is primarily the quality of a country's institutions and policies that determine, over time, its economic fortunes.[1] It is important, therefore to have a clear understanding of what constitutes sound institutions and policies.

By 'institutions' we mean the 'rules of the game' by which people interact with one another. These rules (ie the institutional framework) can be classified into three categories: constitutional rules (that provide the 'superstructure' that regulates the ongoing process of making ordinary laws); operating rules (eg statute laws, regulations and common law decisions) and normative behavioural codes (codes of moral behaviour that legitimise the constitutional and operating rules).[2] By 'public policy' we mean the ordinary laws and programmes – laid down, within a framework of constitutional rules, by the arms of government (parliament, the executive and the judiciary) – that regulate the economy and wider social interactions.

A key concern for policy makers in considering the institutional and regulatory environment is whether a different institutional arrangement or regulatory rule would yield better outcomes. In this sense, the purpose of public policy analysis is to compare different institutional arrangements in order to find the best mix of legislative and regulatory rules on the one hand and private (market and non-market) arrangements on the other. In other words, the task that faces the government is to compare and evaluate alternative ways of ordering social transactions. Which institutional option out of a wide range, extending from different types of private arrangements through to different types of government interventions, is preferred?

This introduction to public policy is organised into two parts. The first part provides a positive analysis of the operation of the economy, and the respective strengths and limitations of different institutional arrangements. By a positive analysis we mean an investigation into 'the world as it is'. This part of the report discusses the nature of the

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1 Refer, for example, to Kasper and Streit (1998), ch 1; IMF (2003); OECD (2003); Rodrik, Subramanian and Trebbi (2002) and World Bank (2006). The International Monetary Fund's *World Economic Outlook* 2003 found that three-quarters of the variation in average income per capita around the world could be explained by differences in institutional quality. Specifically, countries that changed their governments without disruption, limited the power of executive government, respected the rule of law in person and property, and enjoyed low regulatory burdens and an efficient public sector, were likely to be prosperous. Similarly, Roll (2002) estimates that most of the international variation in income per capita – perhaps as much as 85 percent – can be explained by the institutions and policies countries adopt.

2 North (1981).

constraints society faces in economic life, options for addressing these constraints, and the relative strengths and weaknesses of private and government arrangements in helping people achieve their aspirations.

The second part of the report adopts a normative perspective. That is, it ventures into the realm of 'what should be'. The general question being addressed in this part of the report is what institutions and public policies are likely to deliver the best outcomes for New Zealanders. In particular, we consider the objectives of government and the respective roles of the public and private sectors in contributing to society's overall welfare.[3] In discussing what constitutes good institutions and public policy, we draw on theoretical insights supported by empirical evidence on the experience of New Zealand and other countries. This part of the report emphasises the impact of government interventions on the incentives that people face. The report also discusses how the principles and practices of designing policy relevant to a country differ from those that are applicable to commercial and other private organisations.

3 By welfare, we mean much more than monetary values: we mean the full set of values that reflect the aspirations of individuals, including individual freedom, justice, security, peace, financial prosperity and a good environment.

2
POSITIVE ANALYSIS

2.1 The economic problem

The basic constraint society faces is the scarcity of resources (both physical and human) relative to the demands that can be placed on them. Scarcity implies that we face trade-offs. Using resources in one activity means they cannot be used in another activity. Scarcity also implies the need to find means to reconcile the demands of different claimants for the use of the resource and to ensure that resources are used efficiently.[4]

One key resource is information. Despite the huge advances in transmitting and processing information made possible by modern technology, we live inevitably in a world of huge uncertainty. This impacts on us in several ways:

- we have to plan on the basis of a largely uncertain future and we are often required to adapt to change and to adopt strategies that manage or control risk;
- we have to make decisions about how much time, effort and money to invest in obtaining information. Information is costly. There is always some point at which it ceases to be economic to search for additional information;
- in the absence of complete information, we have to make judgments, to rely on rules of thumb and to 'satisfice';[5] and
- some people will invest in the entrepreneurial exploration of what others have found to be impossible and what is unknown.[6] Some people invest money and time in the hope of an outcome that will be proven profitable by sufficient market demand.

The reality is that the modern, knowledge and service-based economy is a complex, ever-changing system in which millions of wants are discovered daily and millions of means to satisfy them evolve. As a result, useful knowledge is often held in non-centralisable, implicit ways. As Hayek noted more than 60 years ago:

> The peculiar character of the problem of a rational economic order is determined precisely by the fact that the knowledge of the circumstances of which we must make use never exists in concentrated or integrated form but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess. The economic problem of society is thus not merely a problem of how to allocate "given" resources—if "given" is taken to mean given to a single mind which deliberately solves the problem set by these "data". It is rather a problem of how to secure the best use of resources known to any of the members of society, for ends whose relative importance only these individuals know. Or, to

4 By 'efficiency' we mean producing the most socially valuable outputs for a given level of inputs.

5 This is the concept of bounded rationality. Simon (1976).

6 Schumpeter (1947).

> put it briefly, it is a problem of the utilization of knowledge which is not given to anyone in its totality.[7]

In addition to scarcity of resources, a further constraint on the achievement of social goals is the interdependencies that exist in everyday life. People's actions and use of resources are likely to impact on other people, either beneficially or detrimentally. Social rules are needed to resolve such interdependencies among individuals in a way that takes account of the welfare of those affected.

The final key constraint on our ability to achieve social goals is that individuals can and do act opportunistically: some individuals will, given the opportunity, steal, shirk on their responsibilities, or seek to renegotiate or renege on previously agreed contracts. The organisation of society would be a lot easier if individuals were always generous, honest and altruistic. Unfortunately, people do not always act that way. Rather, individuals need to protect themselves against the opportunism of others. The realistic response to this problem is not to wish or assume that people will act differently but to devise incentives that harness people's self-interest and limit the adverse consequences of opportunistic tendencies.

In summary, we live in a world where resources are scarce, we face considerable uncertainties, our actions affect other people and we face the risk of opportunism by others. The challenge society faces in such circumstances is to design institutions that relax or minimise these constraints in order to marshal the activities of individuals towards common or consistent ends.[8]

2.2 Organisational choices

There are three main ways in which people can pursue their needs and aspirations. These are:

- voluntary cooperation, such as within families or whanau, where people generally do things for others without being forced to do so and without being paid;
- market exchanges, where transactions are also voluntary but where monetary compensation is made for the supply of goods and services. These transactions are mostly amongst strangers; and
- politics, or collective choice, where decisions are made by voting and individuals cede some of their rights to the government.

Note that in each case the decision makers are individuals. The contrast is not between private choices and the choices of an impersonal entity called 'government'. In a democratic system individuals (voters) elect governments that they hope will reflect their preferences and act as their agents. Government or collective decision making is best thought of as the mechanism individuals have to use to obtain things they cannot obtain through voluntary cooperation or the market.

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7 Hayek (1945), http://www.econlib.org/library/Essays/hykKnw1.html (last accessed July 2007).

8 Economists refer to this challenge as the design of 'incentive-compatible systems'.

Voluntary cooperation is probably the dominant means of getting what we want done. It is the norm in families and small groups. It is also the means of operation for many clubs, associations and charities. It involves redistribution and altruism. It tends to work best in face-to-face situations where people are known to one another.

Markets are essential for society at large to operate. They permit gains from voluntary specialisation and trade. They transmit, through prices, information about customers' needs and suppliers' opportunities. Markets of course are by no means perfect. We discuss in section 2.3 below what are known as 'market failures'.

Governments, likewise, are essential for society to operate. Their core role is to defend the basic institutions a functioning society needs, namely the rule of law, private property and the freedom to contract. Markets need such institutions, as well as customary and moral codes, in order to operate. As is discussed in section 3.2 below, in modern economies governments have a protective, productive and redistributive role. As with markets, however, collective processes may 'fail', as is discussed in section 2.4.

The internal affairs of each of these three broad types of organisations (voluntary cooperation, market exchanges and collective choice) are managed generally by the deployment and observance of rules. The design of these rules or institutions is the central focus of this report. Most of these rules are customary and unwritten, although there are formal rules as well. For example, in a company, social interactions between staff members will be governed by customary rules, although there will also be formal employment contracts and a company constitution.

Relationships among organisations are also heavily reliant on the observation of rules, both formal and informal. Most transactions among organisations are market-based. Organisations purchase inputs from one another and sell outputs to one another. For example, families buy goods and services produced by businesses, but also contract capital and labour to businesses.

The rules within and among organisations can be classified into two categories: those with which people and organisations voluntarily comply (ie voluntary rules), and those rules with which they must comply (ie coercive rules). Most organisational rules fall under the first category.

This distinction between voluntary and coercive rules is what sets the government apart from the other two types of organisation. Government has a unique ability to make coercive rules.[9]

Businesses and families cannot coerce other organisations except by enforcement of a prior agreement or state law.[10] Voluntary cooperation among businesses and families is the best mechanism for ensuring that transactions amongst these types of organisations

9 There are three arms of government, all of which have coercive law-making power, namely, the legislature (which is supreme), the executive (which regulates under the authority of the legislature), and the judiciary (which effectively makes the common law and the law of equity, and interprets legislation).

10 Contracts have constraints during their tenure, but the contracts themselves and the clauses within them are voluntary at inception.

are mutually (and usually socially) beneficial. The limitation and confinement of coercive power to government is generally accepted on grounds of efficiency and fairness. As is discussed in section 2.4, the handing of coercive power to the state can be economically justified on the basis that some outcomes are more efficiently achieved by coercive rules rather than in markets.

The essential social problem is to work out which mechanisms – voluntary cooperation, market exchanges and collective choice – are best used for which purpose. We need them all. Markets can't do everything, nor can governments. And neither markets nor governments can replace the many informal, voluntary associations that exist throughout society. None of these mechanisms is perfect and all-embracing. We have to decide the best mechanism, or combination of mechanisms, to use for the purpose at hand.

Economists refer to this type of analysis as the 'comparative institutional' approach. This approach compares feasible alternatives under the 'real-world' conditions of costly information and self-interested behaviour discussed in section 2.1 above. It leads us to look at the results observed under one set of rules (or institutional environment) against the results expected under another set.

The next two sections of the report consider the strengths and limitations of market exchange and collective choice respectively.

2.3 The strengths and limitations of market exchange

The market system's chief social role is to enable and encourage people to produce efficiently the goods and services that others demand. Markets allow entrepreneurship, which is the basis of wealth creation, to flourish. Despite its weaknesses (as discussed below), the market system of voluntary exchange has, over the past 200 years, transformed the way we live. It has freed many people from relentless toil. It has expanded opportunities, unleashed advances in technology and allowed countless individuals to apply their talents to achieve their own aspirations. It has produced amazing products from penicillin to Prozac, and from gramophones to iPods. Currently, market-oriented reforms in China and India are lifting millions of people out of poverty.

The arguments for the use of markets (or private contracting) as a means of solving economic and social problems tend to focus, at a conceptual level, on three main features of markets:

- first, how markets enable efficient use to be made of information;
- secondly, how markets, through the price mechanism, coordinate individual actions and resolve interdependencies; and
- thirdly, how market competition puts in place a selection mechanism that, over time, tends to guide resources to the highest valued uses, as measured by consumers' willingness to pay.[11]

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[11] For more detail refer, for example, to Hayek (1944 and 1945), Kirzner (1997), Smith (1776) and the Treasury (1987).

On a practical level, one could say that the market system is just the ordinary stuff of life. It is about trading for mutual gain. If firms do their job well and persuade customers to part with their money, they will flourish. If they don't, they won't. Firms respond to the demands of customers by keeping down costs and prices, and by timely innovation. They supply jobs and generate returns on the investments that savers make in them. Through competition, companies are forced continuously to give better value for the consumer's dollar. By making better and cheaper products, and creating new ones, firms make profits for their shareholders and at the same time living standards are raised and countries grow richer.

Economist Adam Smith's insight was that so long as the costs and benefits of a decision are borne by the decision maker, what is good for the individual also tends to be good for society. This implies that rather than being a negative character trait, self-interest can be harnessed in a positive fashion. Indeed, this is the basis of Smith's point that it is not the benevolence of the butcher, the brewer or the baker that ensures that meat, beer and bread are produced – it is due to their interest in 'making a dollar'.[12]

Markets rely on well-defined, secure and tradeable property rights and voluntary contracting to solve the economic problem identified in section 2.1 above. When property rights are well defined, people are discouraged from wasting resources on disputing ownership claims. When the rights are secure, people have an incentive to invest and use the resource efficiently over time. When the rights are tradeable, resources can flow to their highest valued use over time. Case study one illustrates, using the example of water, the damage to the economy and the environment that can occur if rights to a valuable resource are not well defined, secure and transferable.

Despite the many benefits of markets, they have their limitations. These include:

Public goods: where it is very costly (or impossible) to exclude people from enjoying the benefits of a good or service and where consumption of the good or service by one party does not reduce the amount of it available to other potential consumers. In such circumstances, private providers will be reluctant to supply the good or service because people will have an incentive to free-ride on others: providers will not be able to cover their costs and are likely to end up supplying less than the 'optimal' amount of the good or service. One possible example is the local park, which a private operator would not invest in unless access could be charged for. Public goods are discussed further in section 2.4 below.

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12 Smith (1776). For a brilliantly written essay illustrating market processes at work (the so-called 'miracle of the mundane'), refer to the essay 'I, Pencil' by Leonard Read, http://www.econlib.org/library/Essays/rdPncl1.html (last accessed July 2007).

Case Study One: Water and Wastewater

New Zealand faces many problems with its water and wastewater systems. Despite the country's relatively generous endowments of water, shortages are becoming an increasing problem in many regions;[13] the quality of our drinking water is variable;[14] and surface waters and groundwater are being contaminated from uncontrolled or poorly managed stormwater drainage and agricultural runoff.[15]

The problems in our water and wastewater systems can be traced in large part to the inadequacies in our institutions. Property rights for water are often unclear, insecure and not transferable. As a result, users have little incentive to use the resource carefully and there is limited scope for water to be reallocated to higher valued uses. In addition, the public agencies involved with water and wastewater have multiple and conflicting roles and blurred accountabilities[16] and there is a lack of commercial focus in the sector. Further, the regulatory regime is fragmented, with at least 60 Acts of Parliament affecting the water supply or drainage of individual localities, together with a plethora of local regulations.

Price signals for water are generally absent. In most industrialised countries, water is metered and paid for by volume. But in New Zealand there is limited residential water metering and users typically do not face the costs (including the opportunity costs) of their water-use decisions. So in hot, dry weather people soak their lawns and wash their cars with quality drinking water without regard to the true cost of their actions to society.

The problems in our water and wastewater regime have long been recognised. Unfortunately, despite some half-hearted efforts, few improvements have been made. New Zealand's poor track record of reform stands in stark contrast to the progress made in Australia, which has established clear property rights, facilitated the establishment of water markets, corporatised water and wastewater delivery agencies, contracted out billions of dollars worth of water, stormwater and wastewater projects to the private sector and introduced more sensible pricing policies. Its regime, while by no means perfect, is now regarded as one of the best in the world.[17]

The issue for public policy is the proper roles of the public and private sectors in allocating water resources and supplying water and wastewater services. Better institutional design for our water and wastewater system could alleviate both economic and environmental problems. In relation to the allocation and reallocation of water, water markets are likely to have a role to play in delivering sustainable solutions in New Zealand. At the same time, local government has a crucial ongoing role, including in researching the extent of the resource,

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13 An 'infrastructure stocktake' report prepared for the government by PricewaterhouseCoopers (2004) listed seven regions that are experiencing serious summer water shortages, including Canterbury, Otago, Marlborough, the Kapiti Coast and Wairarapa.

14 During 2003, 29 percent of the population was supplied with drinking water that was unable to be shown to comply with the Ministry of Health's Drinking-Water Standards, Ministry of Health (2005).

15 Parliamentary Commissioner for the Environment (2000).

16 The roles and responsibilities of public authorities for water services include being the owner of the infrastructure assets and provider of capital for improvements, customer representative, service provider and regulator.

17 'Liquid Assets', *The Economist* 17 July, 2003.

deciding on the quantity of water needed to protect environmental, recreational and cultural values, monitoring water flows, defining permit rights and enforcing compliance with permit conditions.

With regard to the delivery of water and wastewater services, public policy issues include more efficient pricing (through metering), greater commercial operation of the currently local government-dominated service providers (along the lines of Watercare Services and Metrowater in Auckland), and the scope for more private sector involvement (along the lines of British or French water companies or under contracting-out arrangements, such as the Wellington sewerage operation).

Externalities: where the costs and benefits of a decision are not borne fully by the decision maker.[18] An example might be the noise generated by an aircraft, where people's decisions to fly may not reflect the costs their travel imposes on those who sold land to those living close to an airport. Typically, there are two sides to any such argument – in the case of the noise generated by aircraft, travellers may impose a cost on neighbouring property owners but those owners may have been compensated for this cost if they bought their properties at depreciated values in the first place. (Against this, proximity to the airport could tend to lift land values, raising a question about the net overall effect.) On the other hand, if aircraft use is restricted to certain hours, those living in the neighbouring houses would impose a cost on those who want to travel during the restricted hours. Even if those owning property near the airport experienced a capital gain from restricting airport usage, there would be the issue of whether that gain was worth more than the extra costs imposed on air travellers. As can be seen from this example, the existence of a (non-pecuniary) externality problem is one thing; to decide which rule might produce the best overall outcomes for the community as a whole is another.

More generally, externalities are everywhere and are often simply tolerated. For example, a nice garden is enjoyed by neighbours as well as the owner, but the neighbours are not expected to contribute to the garden's upkeep. In other cases, voluntary contracting may solve the problem: for example, where trees grow over a neighbour's property and the tree owner agrees to trim them. Sometimes government action (eg regulation or subsidy) may be the most efficient solution because it enables society to economise on the transaction costs associated with voluntary contracting. In yet other cases, external effects can go beyond national boundaries and agreements among governments may be necessary (eg to combat problems arising from emissions that affect the global atmosphere). There is no single 'right' answer to the problems associated with externalities: the pros and cons of these different institutional arrangements (ie living with their consequences, voluntary contracting and government intervention) need to be considered on a case-by-case basis.

Monopolies: prevailing technological possibilities can result in the supply of particular goods or services having monopoly characteristics, ie a potential ability to restrict

18 Externalities are uncontracted-for effects that arise either because the relevant property rights have not been well specified or because the costs of contracting to address the uncontracted-for effects are too high.

output and raise prices above some 'competitive' level. Examples often regarded as 'natural monopolies' include electricity transmission and air-traffic control. However, the analysis of such monopolies inevitably depends on the definition of the market (eg is the market electricity or energy; air travel or transport more generally). Further, technology changes over time, old monopolies erode and new ones (eg TradeMe and Google) arise. Undesirable market characteristics such as unfair trading and monopoly rents (where consumers will be willing to pay prices well above cost as there is no alternative supply) can often be disciplined by the market itself. If an individual or firm is earning a return in a particular activity that is above that earned elsewhere, there will be an incentive for others to enter the market and compete, thereby undermining the longer-term survival prospects of such practices. Thus economic rents and privileges tend to be transient in the context of competitive processes, but are likely to develop and persist in the context of arrangements that inhibit such competitive processes (eg monopoly positions conferred by statute, such as ACC and Pharmac).

Information deficiencies and asymmetries: As noted in section 2.1, a major constraint society faces is the cost of obtaining information. People are often uncertain about the quality of the good or service they are contracting for, whether it is a consumer purchasing a car or a computer, a patient seeking health care, or an employer contracting for an employee's services. Often there is an asymmetry in the amount and quality of information the different parties to a potential transaction hold – the seller of a used car, for example, will typically know a lot more about the history and maintenance record of the car than a potential buyer. Because of the costs of uncertainty, people will invest in information collection. Those with superior information will often have an incentive to incur costs to reduce the uncertainties the other party faces. For example, car dealers may offer guarantees on the cars they sell. More generally, individuals and companies may invest in developing brands, chain stores, franchising and different types of contracts as means of signalling to people the quality of the good or service they offer.[19] However, it is only worth investing up to some limit to reduce the costs of search. Ultimately, people have to make decisions with less than complete information.

The limitations to the process of market exchange noted above are sometimes referred to as 'market failures'. However, such terminology is very misleading. It would be absurd to call a golfing champion like Tiger Woods a failure because he is not perfect. It is just as unhelpful to call a market outcome a failure because it is not perfect. The only question that should matter is whether there is a better achievable alternative arrangement. To call a current arrangement a failure is to prejudge the answer to that question.

The concept of 'market failure' is derived from the neoclassical economics model – a model that assumes, amongst other things, that people have perfect knowledge and are fully rational, that transaction costs are zero and that the preferences of individuals can somehow be objectively compared. In neoclassical welfare economics, any departure from this theoretical construct of perfect competition is regarded as a 'failure', which, it is often claimed, can and should be 'corrected' by government intervention.

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19 Akerlof (1970).

This model of perfect competition has little relevance to the design of public policy. It ignores the real problems that society faces – the knowledge problem and the other challenges discussed in section 2.1. Too often claims of market failure are used to justify government intervention without a careful examination of the other side of the coin, namely, the strengths and weaknesses of collective action in dealing with the same problems. It is simply not sufficient to assume that 'government knows best' and that government agents are benevolent.

The limitations to market exchanges arising from transaction costs reflect the inevitable realities of economic life. In some circumstances, private solutions have evolved to reduce the limitations. However, these solutions themselves involve costs and are by no means perfect. In some circumstances, government interventions may be efficient. The next section of the report discusses the relative strengths and limitations of collective (ie government) action in setting the 'rules of the game' and in other activities the government may engage in.

2.4 The strengths and limitations of collective choice

The government plays a vital role in setting the general framework within which all social interactions take place, ranging from rules relating to the right of free speech to rules that govern commercial transactions in the market economy. Governments can be a major force for good, if policies are well designed and suitably implemented. As Pope John Paul II observed:[20]

> The state [has a role] in the economic sector. Economic activity, especially the activity of the market economy, cannot be conducted in an institutional, juridical or political vacuum. On the contrary, it presupposes sure guarantees of individual freedom and private property, as well as a stable currency and efficient public services. Hence the principal task of the state is to guarantee this security, so that those who work and produce can enjoy the fruits of their labours and thus feel encouraged to work efficiently and honestly.

There are a number of advantages to be gained from collective, political action in setting and enforcing rules. In particular:

- we need government to maintain law and order. Because of the tendency for people to act opportunistically (eg to steal), laws are needed to limit the threats to people and their property;
- in enforcing laws, society has generally found it better to give the state a monopoly on the use of force, through, for example, professional police and corrections authorities;[21]
- formal, state-backed rules can also enable society to economise on the costs of contracting that arise in the case of externalities (as discussed in section 2.3 above). A related case is 'hold-up' situations where, for example, it can be efficient for the

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20 Pope John Paul II (1991), www.vatican.va/holy_father/john_paul_ii/encyclicals/documents/hf_jp-ii_enc_01051991_centesimus-annus_en.html (last accessed 20 December, 2006).

21 These functions can, nevertheless, in some circumstances, be subcontracted by the state to private providers, such as private security and private prison operators. Where a function is subcontracted by the state to private contractors it is typically only the operational delivery of that function, not the right to make the rules, that is being delegated.

government to be able to require people to sell land for public roads if voluntary negotiations fail, with market-based payment as compensation; and

- there may be a 'free-riding' problem associated with public goods and externalities (as discussed in section 2.3 above). Where people cannot be excluded from enjoying the benefits of a good or service (ie they can 'free ride'), and consumption of the good or service by one person does not reduce the amount available to others, collective (government) action to ensure provision may increase society's welfare. Examples of 'public goods' include biosecurity, conservation, the machinery of law and order and national defence.[22] Another example of 'free-riding' is the reduction of polluting emissions from a factory, where many people benefit but, individually, people may have insufficient incentive to pay for the pollution reduction. In such circumstances, it may be more efficient for the government to seek a solution to the problem. Policy options for government resolution of problems in general may include regulation (eg of pollution levels), provision of services (eg of defence) or subsidies (eg for public good elements of education).

However, just as markets have weaknesses, so too do political institutions. These can arise because of:

- failures in the political system, where, for example, legislation is passed that panders to particular interest groups (but which a majority of voters would oppose)[23] or where alarmist or populist pressures on politicians result in the passage of unwise regulations in response to perceived problems of the moment ('political failure');
- capture of the regulatory body by the regulated industry ('regulatory capture');
- pressures for the scope and depth of regulations to grow over time ('regulatory creep') as more regulations are needed to offset the unintended consequences of earlier interventions;
- inappropriate bureaucratic behaviour as government agencies seek to promote their own interests rather than the originally stipulated purposes of interventions ('bureaucratic failure'); and
- a sometimes slow, costly and uncertain legal process in enforcing the rules ('judicial failure').

The system of establishing collective preferences through the voting mechanism is a very imprecise and blunt instrument. We typically have to vote for only one or two of several parties, some of whose policies we like and some we dislike. While businesses get feedback on the goods and services they provide when a customer decides to buy (or not to buy) their specific products, the test of overall customer satisfaction for a government is less focused and immediate. The public can express their opinion through such means as polls, protests and letters, but the ultimate test comes at election time and even then the 'customer' only gets one or two votes to choose between packages covering the vast

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[22] What is a public good is a function of the transaction costs associated with being able to exclude people at any given time, and these costs can change with technology. Thus, electronic transponders now make the running of private roads more feasible.

[23] In the case of tariffs, for example, the benefits of protection accrue to a few while the larger costs are spread widely but thinly across the community.

range of policies offered by parties contending for office. Moreover, we cannot signal with our votes how intensely we prefer some things relative to others within our preferred party's bundle of policies.[24]

The blunt nature of the voting system makes it difficult to hold politicians accountable for their actions. In turn, elected politicians can have trouble holding the agencies of government accountable for the implementation of their policies. And, as the body of research known as public choice has taught us, self-interest is also inevitably present amongst politicians and government agents. Politicians' decisions may be based on net political benefits rather than net public benefits.

That is not to question the integrity of politicians and bureaucrats. In most cases they are far more likely to be well intentioned and trying to 'do good' than is commonly perceived. The problem is that good intentions typically cannot overcome the tendencies that are inherent in political systems. For example, there are strong incentives on government to over-regulate. These arise from many quarters, including:

- the pressure on politicians and others in government to be seen to be 'doing something' in response to public clamour;
- the large private costs faced by regulators (eg in the form of public criticism) when something goes wrong; and
- the tendency of regulators to employ people who genuinely believe that the regulatory activity is beneficial and should be expanded.

Recent analysis in Australia of the drivers of excessive and costly regulation pinpoints the role of increasing risk aversion in many spheres of life.[25] Regulation has come to be seen as a panacea for many of society's ills and as a means of protecting people from the inherent risks of daily life. Any adverse event – especially where it involves loss of life, possessions, amenity or money – is laid at the government's door for a regulatory 'fix'. The pressure on government to 'do something' is heightened by intense, if short-lived, media attention.

Former British prime minister Tony Blair made a similar point when he said:

> In my view, we are in danger of having a wholly disproportionate attitude to the risks we should expect to run as a normal part of life. This is putting pressure on policy making [and] regulatory bodies … to act to eliminate risk in a way that is out of all proportion to the potential damage. The result is a plethora of rules, guidelines, responses to 'scandals' of one nature or another that ends up having utterly perverse consequences.[26]

New Zealand's economic history is riddled with examples of the costs and abuses of government. They have included:

- inflation (a hidden tax that penalises, in particular, those on low, fixed incomes);

[24] Refer Friedman (2004) for a discussion of the failures in the political market.

[25] Regulation TaskForce (2006).

[26] Blair (2005), 'Common Sense Culture, Not Compensation Culture', Speech to the Institute for Public Policy Research, London, May.

- periodic recourse to suppression of freedom of choice and contract through extensive controls on prices, wages, rents and interest rates (under, for example, the Economic Stabilisation Act 1948);
- excessive debt (leading to higher tax requirements for a future government);
- excessive tax rates that stifle enterprise and foster state dependency (refer to Case Study Four);
- rights in private property being confiscated without compensation;
- excessive government spending without a rigorous or systematic attempt to determine whether the spending is achieving its ostensible objective;
- generation of state dependency through rewarding dysfunctional behaviour, with intergenerational effects;
- undermining the rule of law by refusing to accept adverse court or regulatory decisions (eg the Telecom unbundling decision);
- moral hazard problems that arise as people become more complacent when they know the government is there to bail them out (eg retirement saving, ACC and banking regulation);
- the creation of statutory monopolies that raise costs and restrict choice, benefiting providers at the expense of the public at large; and
- middle-class welfare and other perverse effects that can arise from often well-intentioned interventions (eg many social policies – such as government subsidies to tertiary students – result in the transfer of wealth from the less well-off to the better-off members of society).

When discussing the costs imposed by government on businesses, business people often focus on the administrative and compliance costs of government action. These costs, while significant, are often far less than the broader economic costs of government intervention noted in the preceding paragraph.[27] For example, the costs of obtaining resource consents under the Resource Management Act 1991 can be dwarfed by the economic costs of delays and the economic benefits forgone when worthwhile projects don't proceed at all.

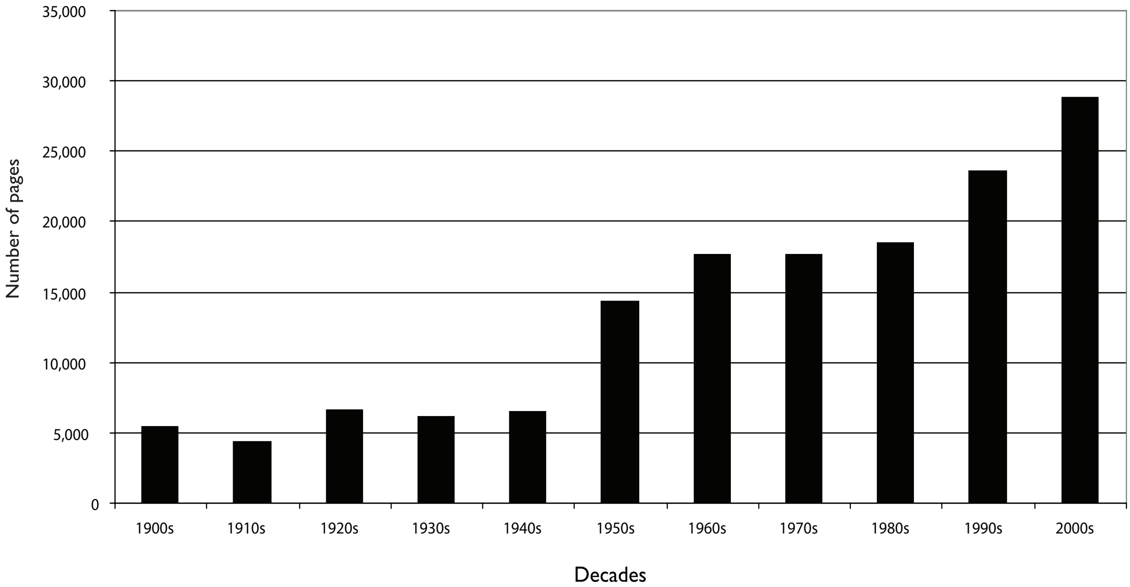
The amount of legislation affecting New Zealand businesses and households has grown rapidly over the last two decades. The following graph shows the number of pages of new primary legislation (ie new Public, Private and Local Bills) passed each decade in New Zealand since 1900.[28] The data show that the number of pages of new primary legislation has increased substantially over the last century. Moreover, the pace of growth has picked up markedly again after a period of deregulation in the 1980s and early 1990s.

The figures in the graph exclude secondary and tertiary legislation (regulations), which, if included, would significantly inflate the totals. The Annual Report of the

[27] In the United States, for example, the economic costs of federal regulations in 2005 were estimated to be US$1.1 trillion, or almost half the size of total federal government spending (refer Clyde Wayne Crews, 'Ten Thousand Commandments: An Annual Snapshot of the Regulatory State', Competitive Enterprise Institute, Washington DC, June 28, 2006, http://www.cei.org/gencon/ 025,05407.cfm) (last accessed July 2007).

[28] Figures for the current decade are extrapolated from actual figures for 2000 to 2005.

Figure 1: Number of pages of new primary legislation by decade: 1900s to 2000s



Source: Parliamentary Library.

Parliamentary Counsel Office shows that in the 2005 financial year, 9,327 pages of new primary and secondary legislation were published.[29] This was the highest number in New Zealand's history.

Further, the Parliamentary Counsel Office figures don't include one of the growth areas of new regulations – so-called 'deemed' regulations and tertiary legislation. These include Maritime Rules, Land Transport Rules, Gazetted Notices, Privacy Codes, Health Codes and numerous others regulations issuing from government agencies. As law professor Michael Taggart noted in the Alexander Turner Chair Inaugural Lecture:

> The State has not retreated in any real sense since the 1980s, but rather has engaged with the private sector in very complicated patterns of interrelationship and interdependence, often in considerable tension. The rhetoric of deregulation, competition and privatisation deceived people into thinking there must be less, rather than more rules. This is not true. The resultant pattern of "mixed administration" has led to more delegated legislation, increased delegation of governmental functions to the private sector and more soft law …[30]

At least since *Magna Carta* (1215), free societies have wanted to place limits on sovereign power and to insist on certain basic rights and freedoms being 'retained by the people'. At first the battle was to constrain authoritarian rule by kings and queens (especially the power to tax). In modern times, the struggle has been to control the abuse of parliamentary power. Options for limiting the scope and scale of government are discussed in section 3.2 below.

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29 Report of the Parliamentary Counsel Office for the year ended June 2005, http://www.pco.parliament.govt.nz/corporatefile/annualreport/2005/2005report.shtml#outputs (last accessed July 2007).

30 'The chequered history of delegated legislation in the 20th Century', University of Auckland, 26 October, 2005.

3
NORMATIVE ANALYSIS

3.1 The objectives of government

Conventional welfare economics proposes that the objective of public policy is to maximise the nation's overall welfare. In this vision, governments should do what is good for society.

While that is a noble vision, there are two flaws with it. First, 'societal welfare' cannot be identified except through processes of identifying and aggregating individual preferences. Aggregating individual preferences, however, is tortuous and fraught. As Nobel-prize winning economist Kenneth Arrow showed, no coherent collective preference system is possible based on individual preferences with plausible properties.[31] A classic demonstration of Arrow's 'impossibility theorem' was the failed attempt by the New Zealand government in the early 1990s to define the 'core health services' that would be funded by central government.

Secondly, the conventional welfare economics approach presupposes governments are inclined to act in the public interest. As discussed in section 2.4 above, political incentives are usually for a party to get re-elected, which is not the same thing.

A better approach, we believe, is to take the objective of public policy as being to create an environment that allows citizens to maximise their own welfare – ie to promote human flourishing in self-chosen ways. By welfare, as noted above, we mean much more than monetary values: we mean the full set of values that reflect the aspirations of individuals, including individual freedom; justice, security, peace, economic welfare (or prosperity) and a good environment. Freedom, in particular, is a value that seldom features in official policy analysis (see Case Study Two).

In the short term, there may be conflicts between these various monetary and non-monetary objectives that require policy compromise. Over time, these objectives are less likely to be in conflict. For example, greater economic freedom tends to be associated with higher living standards and better social indicators, such as longer life expectancy, lower infant mortality rates and improved access to water.[32] Higher living standards tend to be associated with better, not worse, environmental outcomes.[33] Similarly, rising living standards tend to assist those on all incomes, including those on the lowest incomes.[34]

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31 Arrow (1951).

32 Gwartney and Lawson (2006).

33 Lomborg (2001).

34 Dollar and Kraay (2001), Gwartney and Lawson, *op cit*, and OECD (2006).

Case Study Two: School Choice

While the New Zealand school system delivers a good education to many, there is a large gap, by OECD standards, between children at the bottom and at the middle of our achievement range: that is, we have a long 'tail' of underachievers.[35] In 2006, for example, nearly half of Maori and 37 percent of Pacific Islands school leavers did not reach an NCEA Level 1 qualification.[36]

There are many complex factors behind these statistics, but we know that some schools get better results from these groups of students than others. Schools matter, regardless of students' socioeconomic backgrounds. We also know that many parents, given a choice, vote with their feet and move their children from failing schools to more successful ones.

The pattern of New Zealand's school choice policies over the last three decades has been erratic. The policies have included, among other things, the *Tomorrow's Schools* initiatives of the 1980s, which increased school autonomy and parental involvement; increases followed by cuts to funding of independent schools; and the abolition in 1991 of school zoning, which was subsequently partially re-imposed.[37]

Restrictions on school choice run counter to the interests of those most in need of help. Well-off families are likely to retain greater choice in education – whether by sending their children to private schools or moving into the zones of high-performing public schools. Restrictions on choice may simply end up locking the poor and disadvantaged out of quality education.

Critics of choice often focus on the impact on schools, rather than its impact on students and student achievement. As a result, roll declines at schools are seen as a bad thing, when in fact they may be a good thing if students are leaving inferior schools for better ones.[38]

The ability of schools to open, expand and close in response to increased or reduced demand is one of the three essential design elements of successful school choice policies outlined in a recent paper by Harvard University professor Caroline Hoxby.[39] The two other critical factors Hoxby identifies are: funding following the student, so that all schools (public, private, for-profit and non-profit) are on the same footing; and independent management, so that schools are free to innovate in areas such as teaching practices, teacher pay and school organisation.

The government has a role in education. That role should be driven by principles rather than special interest politics. A first-principles approach would ask whether the 'customers' – the children and their parents – are likely to be better served by a local monopoly or by competing suppliers. It would also ask whether, as a matter of principle, the government or parents should decide which school a child should attend.

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35 UNICEF (2002).

36 NCEA Level 1 corresponds to the former School Certificate (form 5) level of education.

37 In 2003, 37 percent of schools in Auckland, 18 percent of schools in Canterbury and 17 percent of schools in Wellington were limiting enrolments (LaRocque, 2005).

38 Harrison (2004), pp 219–33.

39 Hoxby (2006).

A number of studies have been conducted on the effects of school choice on educational outcomes and other indicators. While some studies yield different conclusions, there is a growing body of evidence that school choice generally leads to increased parental satisfaction, improved academic achievement, as well as improved public school performance.[40]

While improved educational performance may be one public policy goal, there is also a case for recognising freedom as a value in and of itself in public policy analysis (along with efficiency, equity and other values). For example, the Catholic bishops of New York State argued in a pastoral letter that the main argument for school choice had to do with individual freedom:

> While a system of parental choice and school competition would have a positive effect in improving schools, this argument is beside the point. The purpose of a system of parental choice is to enable parents – all parents – to exercise their inherent right and responsibility to direct the upbringing and education of their children. Even if all schools were high performing, the rationale for a system of parental choice remains. The freedom to choose the education best suited for one's children is a basic right of all parents, regardless of income.[41]

This right is enshrined in human rights conventions and was an influential factor in Sweden's move to an education voucher system (whereby government and non-government schools are funded on a similar basis). School choice is longstanding and uncontroversial in the Netherlands, Ireland and Denmark.

3.2 The role of government

The positive analysis in section 2 on the nature of the economic problem and the strengths and weaknesses of alternative ways of arranging society provides a basis for discussing the normative question of what makes for good government, and good economic management in particular.

Following the discussion in section 2.4, three core functions for government can be identified:[42]

- the protective role of the state
- the productive role of the state, and
- the redistributive role of the state.

The protective role of the state covers the essential functions of maintaining law and order, defining property rights, modifying rules of the economic game, adjudicating disputes about the interpretation of rules, enforcing contracts, engaging in activities to counter technical monopolies, and overcoming uncontracted-for effects widely regarded as sufficiently important to justify government intervention. It also includes supplementing the family and private charity in protecting children and those who are chronically impaired, for example, because of illness, old age or drugs.

[40] Lips, D and E Feinberg (2006), "School Choice: 2006 Progress Report", *Backgrounder* No 1970, Heritage Foundation, Washington, DC.

[41] http://www.cny.org/archive/ft/ft090502.htm (last accessed July 2007).

[42] Refer Buchanan (1975).

The productive role of the state relates to public goods where, as discussed above, public funding is required to ensure an appropriate delivery of such activities as courts, defence, foreign relations and police. However, even in such cases, the private sector can play a useful role in some circumstances in providing parts of the public good or service.[43] When it comes to commercial goods and services (ie those that can be charged for), experience indicates these are best left to the private sector. The empirical evidence indicates overwhelmingly that public trading enterprises are not as efficient as privately owned enterprises on average and over time.[44] In such circumstances, the government's role is better restricted to being a regulator rather than a provider. Indeed, if the government owns commercial enterprises, its joint roles as both player and referee lead inevitably to conflicts of interest. A recent example arose in the case of the majority state-owned airline, Air New Zealand, when the government was asked to approve its proposal for a trans-Tasman 'code-sharing' arrangement with Qantas.

The redistributive role of government is to assist the poor and protect the weak in society. Some individuals have inadequate resources or lack the capacity to pursue their own welfare satisfactorily. In these cases individual and collective action redistributes income to assist the poor. In 2005/06, around $15.6 billion (or 31 percent of total core Crown expenses) was spent directly on various social services in New Zealand.[45]

While income support is a valid government role, there is much to debate about the nature of that safety net – about its level, whether assistance should be in the form of cash transfers or specific services, and who should be eligible to receive them. There are also valid grounds for concern about the role of the government in crowding out voluntary collective charitable activities that might be more sensitive to the need to give people a hand up or hand out.[46] Government assistance, if it is well targeted and temporary, may assist those in need but if it is poorly targeted and open ended, people may end up in a cycle of dependency. Equity issues are discussed further in section 3.3 below.

Government activities need to be financed. This should be done with the least distorting tax system possible. People should be incentivised to pursue market opportunities and not be unduly diverted from sound business endeavours by artificial tax considerations. Therefore, the tax system should be broad-based with low rates of tax. High tax rates on marginal income, by contrast, can damage economic growth by blunting incentives to work, save, invest and take risks. Currently, effective marginal tax rates faced by some welfare recipients exceed 100 percent,[47] meaning that such people have little incentive to reduce their dependency on the state. If they earn extra money, their after-tax income actually declines.

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43 For example, some aspects of defence and foreign affairs services, like routine supplies and services, and some aspects of maintenance can be and regularly are contracted out.

44 Refer Barry (2002), Galal *et al* (1994), Gonenc *et al* (2000), Megginson and Netter (2001) and Shirley and Walsh (2000).

45 *Financial Statements of the Government of New Zealand for the Year Ended 30 June 2006*, table 3, p 9; http://www.treasury.govt.nz/financialstatments/year/jun06/cfsyjun06.pdf (last accessed July 2007).

46 Refer Green (1996).

47 IRD (2005), pp 25–28.

Beyond these basic functions of government, the case for further government intervention in the economy should be considered on a case-by-case basis. Such an analysis should, at a minimum, address the following three key questions:

- what is the policy objective or problem to be addressed?
- what are the feasible options (government and/or non-government) for achieving the desired objective(s)?
- are the benefits of government intervention likely to outweigh the costs?

All three steps are essential for sound policy analysis.

All too often the first step – problem definition – is missing or done inadequately. The result may be a solution in search of a problem. The recent introduction of KiwiSaver is arguably such a case. There is no clear evidence that New Zealanders overall are poor savers.

The second step – considering the range of options – needs to be comprehensive. The menu of possible options is wide and includes:

- modification of the legal framework within which commercial activity takes place;
- fiscal subsidies or taxes;
- legal restraints on prices, quantities or entry into some activity;
- government ownership in varying degrees of commercial enterprises; and
- direct provision of social and economic services by government agencies.

An often overlooked aspect of this second step is to consider whether the source of the underlying problems may be existing government policies. For example, the recurring problems of insecure supply in the electricity sector, rather than justifying further interventions, may be due, at least in part, to the state's multiple and conflicting roles in the sector.[48]

The third step – assessing the costs of government intervention against the benefits – is perhaps the most difficult. Simply identifying a 'market failure' isn't sufficient to justify government action. The various costs (or 'failures') of government intervention also need to be considered. As various commentators have noted, just because markets aren't perfect doesn't mean the government can do any better.

Further, while a sound framework of regulation is needed to facilitate business transactions and help achieve other economic and social goals, statutory intervention is not necessarily required. The alternative to statutory regulation in any particular business

48 The government currently has a pervasive influence in the electricity sector. It owns three of the five major electricity generators; owns the transmission network (through Transpower); regulates Transpower's pricing decisions (through the Commerce Commission) and its investment decisions (through the Electricity Commission); and sets (through the Commerce Commission) price and quality thresholds for the country's 28 electricity lines companies. Investment decisions in the sector must also be made currently in the context of additional uncertainty regarding the industry's Kyoto Protocol obligations; poorly defined property rights for natural resources (refer, for example, to Case Study One on water rights); the current Commerce Commission investigation into the pricing behaviour of the generators; and against the background of direct government involvement in the country's latest major new generation projects (ie Whirinaki and e3p).

area is not no regulation but rather regulation by the common law and relevant private codes and practice.[49]

The cost-benefit framework described above for assessing government intervention is a good starting point.[50] Certainly it is better than the approach that often underlies calls for government intervention in New Zealand (ie that 'if there is a problem, the government must fix it'). However, cost-benefit assessments of whether the government should intervene or not are unlikely to be sufficiently robust to be relied on exclusively when designing public policy (refer Case Study Three). The risk that elected or appointed government officials may be motivated to seek power and exercise it for their own benefit rather than allow citizens to maximise their overall welfare must be considered in the design of policy. The reality is that much government intervention that purports to be in the general public interest is in fact a response to self-interested lobbying by narrow groups.

Policy analysis in government commonly fails to take political and bureaucratic incentives seriously. Regulatory impact analyses often assume that the preferred outcome will achieve the desired results without material unintended and undesired consequences. Sound public policy advice must consider how current and future governments are likely to behave, not how the analyst would like governments to behave.

In democratic states, few policies take the form of the government commanding directly the results it wants. Policies generally operate indirectly by influencing the incentives people face. There is considerable scope for governments to design institutions and policies that encourage people to improve their welfare. For example:

- fees for tertiary students provide students with incentives to select courses that enhance their lifetime enjoyment and earnings, to demand better performance from their teachers, and to study harder to get better marks; and
- ways of promoting social welfare that are consistent with better economic performance take advantage of the strengths of individual incentives. For example, in the United States the Earned Income Tax Credit (EITC) scheme has received support from both ends of the political spectrum as a relatively well-targeted federal social assistance scheme that encourages the poor, particularly single parents, to engage in employment.[51] More broadly, among the most effective ways for countries to achieve welfare objectives may be labour market institutions that permit human capital development and effort to be rewarded and a tax system that encourages entrepreneurship and work.

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49 In the Anglo-Saxon countries, the common law is sometimes called judge-made law as it arises from rulings made by judges, not politicians. Typically, common law develops in an incremental fashion that responds to the need for justice for those appearing before the judges and is respectful of business customs and property rights.

50 Such a cost-benefit framework underlies the guidelines provided by the Ministry of Economic Development (1999). A similar approach is followed in the Legislation Advisory Committee Guidelines, Legislation Advisory Committee (2005).

51 Similar schemes, the Working Tax Credit and the In-Work Payment, are in place in the United Kingdom and New Zealand respectively. The In-Work Payment is less tightly targeted than the EITC.

Case Study Three: The Limitations of National Cost-Benefit Analysis

Each year, New Zealanders spend large amounts of money on Christmas presents. Yet how many of us get presents that we don't want: perhaps an uncool shirt from aunty or that packet of playing cards from uncle? An economic analyst might well conclude that there is enormous waste in giving presents at Christmas time, with people receiving presents that are of less value to the receivers than the cost to the givers. The policy conclusion might be that we would be better off to ban Christmas presents – any gifts in future would have to be in cash so that the value to the recipient equalled the cost of the present to the giver.

The key flaw in any such analysis is that other values such as freedom are being overlooked. People enjoy giving, for whatever reasons, and simple cost-benefit analysis does not always capture the value that individuals place on their actions, no matter how 'irrational' such behaviour may appear to be.

Cost-benefit analysis has its place: indeed, as is suggested in section 3.2 of this report, a systematic assessment of the costs and benefits of government interventions is a prerequisite for sound policy analysis.[52] But it also has limitations.

A far more serious example of the limitations of cost-benefit analysis is New Zealand's experience with the government-sponsored 'Think Big' energy investments of the late 1970s and early 1980s.[53] These projects were all evaluated using cost-benefit analysis and, based on certain assumptions, were expected to deliver a return above the 10 percent (post-inflation) public sector discount rate benchmark. In fact, the projects turned out to be an economic disaster, costing the country hundreds of millions of dollars.[54] While the failure of the projects was due in part to oil prices turning out to be much lower than was projected, the problems were also more fundamental. National cost-benefit analysis was an inadequate test for such commercial investments. The real question that needed to be asked concerned the appropriate role of the government in relation to these activities. As the Think Big experience highlighted, government officials and ministers are unlikely to have either adequate information or the proper incentives to make sound commercial decisions.

The importance of incentives and the principles of good economic analysis are recognised across the traditional right–left spectrum. For example, when passing the most wide-ranging reforms of the social welfare system the United States has seen in over 30 years,[55] President Clinton, a Democrat, championed the role of policies that encourage people to move from welfare to work and give them a 'hand-up' rather than a 'hand-out'. Similarly, Ken Livingstone (who has been nicknamed 'Red Ken'), the Mayor of London, recognised that price signals and incentives matter when he introduced a traffic charge to reduce

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52 For an introduction to cost-benefit analysis, see for example, A Boardman *et al* (1996) and R Layard and S Glaister (1994).

53 The projects included ammonia-urea, methanol and synthetic gasoline plants, and expansions of the Marsden Point refinery and the Glenbrook steel mill.

54 The Treasury (1984a).

55 The Personal Responsibility and Work Opportunity Reconciliation Act 1996.

congestion levels in central London.[56] More generally, over the last decade, centre-left and centre-right governments across much of Europe have been reducing personal income tax rates, reforming social welfare systems (albeit in a piecemeal fashion) and privatising state-owned businesses.

Arguably, however, the fundamental policy challenge is how to constrain governments by designing institutions so that their decisions reflect the broader public interest. Various New Zealand governments have risen to this challenge by passing legislation that makes the government's actions more transparent and constrains their ability to intervene. Examples include the State-Owned Enterprises Act 1986, the Reserve Bank of New Zealand Act 1989 and the Fiscal Responsibility Act 1994 (now part of a re-enacted Public Finance Act 1989). These statutes have remained largely unaltered by subsequent governments. Broader institutional arrangements such as the separation of powers among parliament, the executive and the courts, and the role of common law, are also important in this context.

There is scope for further improvements in public policy in the same vein, including through the adoption of more constitutional approaches to government spending, taxation and regulations.[57] These approaches would put more emphasis on the principles of consent to taxation, compensation for the taking of private property and no delegation by parliament of the authority to tax or spend. Improvements in public policy would also involve systematic assessments of the quality of government intervention. A relevant question, for example, would be why the central government owns over $30 billion of assets in commercial businesses when it can almost certainly achieve its objectives in a more efficient and equitable manner without ownership.

The imposition of 'rules' on government, such as through constitutions, is not the only way of constraining government. There should also be sound processes for government decision making. The government does not always know best (because much information is inevitably decentralised, as noted in section 2.1 above), so proper consultation with business and community groups should inform the evaluation process. A requirement to make transparent to the wider community the information relied upon by the government to legislate or regulate can itself be a discipline on the exercise of power. Further, built-in mechanisms such as sunset clauses in legislation and periodic reviews can help to ensure that government interventions remain relevant and effective over time.

Ultimately, however, the openness of our international goods, capital and labour markets is probably the most important long-run source of constraints on political opportunism. The ability of New Zealanders to migrate and the ability of capital to leave the country rapidly (with immediate consequences for the exchange rate and interest rates) place a check on governments that is more powerful than many legislative constraints (since these can always be changed). Further, as is noted in section 2.3 above, open markets also help discipline participants in them, thus minimising the need to resort to regulation.

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56 The charges are estimated to have reduced congestion levels by around 15 percent and Livingstone intends to extend the zones in which the charge applies: http://en.wikipedia.org/wiki/Ken_ Livingstone (last accessed July 2007).

57 Wilkinson (2004) and (2001).

3.3 Equity

The notion of equity, or fairness, features frequently in economic and social debate. Fairness is an important social goal. Often, however, policies advanced in the name of fairness do not withstand critical scrutiny. Equity needs to be analysed rigorously, just like any other social goal.[58] Often policies such as subsidies to higher education, state-owned housing, universal pensions and occupational regulation that are advanced in the name of equity can end up helping those who are relatively well off, while creating welfare dependency and the growth of an underclass.

For an analysis of equity to be useful, the concept needs to be carefully defined. What people mean by equity can differ widely and it can be used to justify all manner of policy conclusions.

If equity is defined as equal treatment of equals, equality before the law, or a compassionate concern for the genuinely needy, then it deserves a place among our moral beliefs. However, if equity is defined as equality of outcomes or material wealth or income, it should be rejected – both because it cannot be achieved and because a system trying to achieve it is likely to do more harm than good. The objective of striving to provide fair opportunities is a more practical guide for policy, and better than the idea of pursuing equal opportunities, which is also utopian and can become tantamount to equality of outcomes (see Case Study Four).

To the extent that the government has redistribution aims, the choice of policy instruments is important. Policies like regulation and state ownership of commercial businesses are invariably blunt and inefficient instruments for achieving equity objectives. Redistribution aims are generally best achieved through direct and transparent taxes and subsidies.

However, even relatively efficient government policies for redistributing income, like direct taxes and subsidies, have their costs and limits. Income transfers can have only a modest impact on poverty, and they bring potential problems of dependency in their train.[59] Moreover, every extra dollar of tax raised has a hidden deadweight cost associated with it through the distortionary effects of taxation on people's behaviour.[60]

Over time, economic growth is likely to be the most powerful anti-poverty strategy. As former President Bill Clinton noted,

> Open markets … are the best engine we know of to lift living standards … and build shared prosperity.[61]

Productivity gains are the only long-run source of higher incomes. Higher incomes in turn enable people to consume more of the goods and services that are important to them. These include food and clothing, housing, transport, health, education, the arts,

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58 Refer, for example, to Buchanan and Hartley (2000).

59 See Harrison (2007).

60 Treasury guidelines provide for a figure of 20 percent to be applied to the costs of government expenditure funded from taxation to reflect the deadweight loss. Refer The Treasury, 2005, p 18.

61 Bill Clinton speaking at the World Economic Forum (2000).

environmental goods, religious and charitable activities, and all the other activities that people enjoy.

Finally, if one thinks about what public policies will be most conducive to maximising overall welfare, good rules known in advance are important. It is generally unfair as well as inefficient to change the rules after people have made irreversible investments in specific assets.

Case Study Four: Marginal Tax Rates

Tax arguably has a greater impact on most people's lives than any other government intervention. With spending by central and local governments at around 40 percent of GDP, the average person must spend two days in every week working to pay the taxes necessary to fund that level of government expenditure.

A lowering of taxes across the board requires constraints on government spending. If such constraints can be achieved, there is a good case from an overall economic efficiency point of view for lowering marginal tax rates.

A lower and flatter tax scale has many advantages. It encourages people to work, produce and innovate. It also reduces the incentives to avoid and evade taxes, to the detriment of accounting firms and tax lawyers but few others. Lower tax rates also make it possible for the government to apply taxes to a broader range of activities. Distortions between different activities and investment vehicles could be reduced as a result. Cutting the top tax rates would also enable the tax system to be simplified.

The principal argument raised against the lowering of marginal tax rates is a perceived equity one. There is little or no debate in New Zealand that a legitimate role for government is to provide a welfare safety net for those in genuine need of state assistance. But this does not call for a so-called progressive tax, whereby marginal tax rates rise with income levels. Even a single proportional rate of tax involves substantial redistribution. For example, with a tax rate of 20 percent and no exemptions, a person earning $200,000 would pay tax of $40,000 whereas someone on $30,000 would pay only $6,000. Moreover, as the McLeod Tax Review[62] noted, most redistribution of income by the government takes the form of government expenditure measures rather than taxation, through programmes like education, health and social welfare benefits to those on low incomes.

Overall, efficiency considerations would argue for a lower, flatter tax scale. Equity arguments may result in a similar conclusion being reached. Progressive marginal tax rates are more equitable than a single proportional rate of tax only to people motivated by envy with regard to high incomes, not compassion for the poor.[63]

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62 Tax Review (2001).

63 See Buchanan and Hartley, *op cit*, pp 170 ff.

3.4 A country is not a company

The design of rules for governing a country is different from the design of policies that apply to the governance and management of a company.

It may be appealing to think that running the government is just an extension of running a large company. However, there are many differences between the government and a company. The fundamental one is that the government generally sets the rules of the game whereas a company is a player in the game. As a result, government is about the normative – what should be – whereas a company by and large takes the rules as given and seeks to maximise long-term returns to its owners within the rules.

As rule-maker, the government has coercive power – it can require everyone to play by the rules or face the consequences. A company, on the other hand, must rely on voluntary cooperation to prosper – it must produce a product that people want to buy and offer its workers sufficient rewards to recruit and retain them.

While governments in a democracy must also ultimately produce a package of services that the majority of people want, the performance feedback mechanisms in a government are more diffuse and less immediate than the commercial world (as was discussed in section 2.4). A company, for example, has incentives to exit from a failed project reasonably quickly. It is not so easy for politicians to openly admit a mistake because of the incentives for the media or opposition MPs to highlight the error. Similarly, in the private sector, unsuccessful managers, companies and entrepreneurs generally get removed relatively quickly. On the other hand, it is harder to discipline or replace bad political managers.

Another difference is the complexity of the objectives of a government. A company's objective is relatively simple: it is to maximise the long-term returns to its shareholders, subject to obeying the law and maintaining ethical standards. In doing so, it may have an overriding vision and strategy. The government, on the other hand, has to balance a range of goals such as efficiency and equity, which can require trade-offs to be made. Moreover, people can legitimately hold different views on a range of issues; indeed they may have strong disagreements. These should be respected in a democratic system. Ideas of overall 'national visions' and 'national strategies' that are universally supported are suspect.

Further, the typical chief executive will often take a 'hands-on' approach to running the business, whereas a 'hands-on', 'picking winners' approach is likely to be a poor approach to running a country. That is not to say that successful chief executives don't put a lot of effort into developing an organisational culture that generates ideas and incentives to foster better performance. But, as University of Chicago law professor Richard Epstein has noted:

> A company is a centrally planned institution, in which decentralised decisions are made only with the blessing of those at the top of the pyramid; ultimately the chief executive, subject to the supervision of the board of directors. A firm could not survive with uncoordinated decisions made by decentralised agents in spot markets.
>
> A sound economy functions quite differently. Central planning does not work. Decision-makers at the centre lack the information and incentives to put society's resources to best use.

> [In an economy] we need markets and prices to first collect and then utilise dispersed information, which in turn permits the easy coordination of the behaviour of producers and consumers. A good institutional and legal framework is required to facilitate voluntary exchange. Running a market economy is a matter of getting the road rules right, not directing all the economic traffic.[64]

Finally, while many people have opinions on public policy, the design of good public policy is a specialist subject – just as much as engineering, medicine or architecture – and requires a similar level of expertise. For example, the devising of appropriate tax rules is a technical exercise, requiring expertise in aspects of economics, accounting and law. That is not to suggest that the public can or should be excluded from debate about public policy, rather that many areas of public policy are not susceptible to simplistic or intuitive analysis. So-called 'Do-It-Yourself' economics can be a more malign influence on public policy than mistaken economic theories.[65]

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64 'Handouts no boon to business', *New Zealand Herald*, 18 July, 2005.

65 See David Henderson (1986).

4
CONCLUSIONS

We live in a world where resources are scarce, uncertainties abound, our actions affect other people, and there is a risk of opportunism by others. Given these circumstances, the challenge faced by public policy makers is to design institutions that relax or minimise these constraints and promote a 'harmony of interests'.

Voluntary non-pecuniary cooperation, markets and politics are the three broad means available to people to achieve their aspirations. Each has its advantages and limitations but each has an essential role to play.

The analysis in this report recognises a significant role for government. That role includes maintaining law and order, defining secure and tradeable property rights, providing sound money, adjudicating disputes about the interpretation of rules, enforcing contracts, promoting competition, ensuring public goods are provided adequately, controlling serious monopoly problems, and supplementing the activities of families and private charities in assisting those on low incomes and those in need of protection.

No government can perform these essential duties unless it has enough power, including the power to tax. Along with power, however, comes the threat of abuse of power. Experience teaches us that it is necessary to impose well-considered constraints to protect individuals from the abuse of power by government. It also suggests a healthy suspicion of government intervention is required. As *The Economist* noted some years ago:

> The biggest economic-policy mistake of the past 50 years, in rich and poor countries alike, has been and still is to expect too much of government. Statism has always found all the support it needs among mainstream economists. They are usually quick to point out various species of market failure: they are usually much slower to ask whether the supposed remedy of government intervention might not, in practice, be worse.[66]

Arguably the central policy problem in a democracy is not to discover what governments might do to improve overall welfare. Instead, it is to consider how best to make it harder for governments to reduce welfare in the short-term pursuit of votes. In any such analysis the assignment of the burden of proof is critical. All in all, a strong presumption in favour of free exchanges in open markets seems wise. This is not because economic theory says so, but because experience strongly points in that direction.

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[66] 'The puzzling failure of economics', *The Economist*, 23 August, 1997.

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