



Structural
Adjustment
*Exploring the
Policy Issues*

Workshop
Proceedings

© Commonwealth of Australia 1999

ISBN 0 646 33594 4

This work is subject to copyright. Apart from any use as permitted under the *Copyright Act 1968*, the work may be reproduced in whole or in part for study or training purposes, subject to the inclusion of an acknowledgment of the source. Reproduction for commercial use or sale requires prior written permission from AusInfo. Requests and inquiries concerning reproduction and rights should be addressed to the Manager, Legislative Services, AusInfo, GPO Box 1920, Canberra, ACT, 2601.

Inquiries:

Media and Publications
Productivity Commission
Locked Bag 2
Collins Street East Post Office
Melbourne Vic 8003

Tel: (03) 9653 2244
Fax: (03) 9653 2303
Email: maps@pc.gov.au

An appropriate citation for this paper is:

Productivity Commission 1999, *Structural Adjustment — Exploring the Policy Issues*, Workshop Proceedings, AusInfo, Canberra.

The Productivity Commission

The Productivity Commission, an independent Commonwealth agency, is the Government's principal review and advisory body on microeconomic policy and regulation. It conducts public inquiries and research into a broad range of economic and social issues affecting the welfare of Australians.

The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by concern for the wellbeing of the community as a whole.

Information on the Productivity Commission, its publications and its current work program can be found on the World Wide Web at www.pc.gov.au or by contacting Media and Publications on (03) 9653 2244.

Foreword

Policy issues relating to structural adjustment are central to the debate on the future direction of microeconomic policy in Australia. In recognition of the importance of these issues, and as a way of further developing our own thinking, the Productivity Commission commissioned five leading policy analysts to prepare papers for a workshop held on 21 May 1999 in Canberra.

The workshop was organised around two main themes.

- The first, *Evaluating policy changes — the economic and social dimensions* explored issues such as: how adjustment and distributional issues should be dealt with in the process of evaluating specific policy changes; the relevant decision criteria for evaluating policies; and the extent to which governments should trade off efficiency gains from reform against equity, regional development or other considerations.
- Within the second theme, *Delivering effective adjustment assistance*, issues examined included the case for selective adjustment and compensatory assistance, the role of different transitional arrangements and the packaging of reforms.

Around fifty participants attended the workshop, including academics, senior government officials, consultants and representatives from social and business groups and the union movement. We would like to thank all the participants for their active involvement in an illuminating discussion. We are particularly grateful to the authors of the commissioned papers and to the discussants, who produced quality contributions that will greatly assist the development of our thinking.

The workshop was organised by Ian Monday, Rosalie McLachlan, Colin Clark, Timothy Geer and Amelia Lindsay, who also compiled the proceedings, with assistance from Roberta Wise.

Gary Banks
Chairman
August 1999

Contents

Foreword	III
Abbreviations	VIII
PART A INTRODUCTION AND OVERVIEW	
1 Introduction	1
<i>Gary Banks</i>	
2 Overview	7
PART B COMMISSIONED PAPERS	
3 Distributional effects of structural change: some policy implications	39
<i>Fred Argy</i>	
4 Policy issues in structural adjustment	93
<i>Malcolm Gray</i>	
5 Structural change, growth and ‘social justice’ — an essay	125
<i>Wolfgang Kasper</i>	
6 Issues in structural reform	163
<i>Elizabeth Savage</i>	
7 Structural adjustment: a mainly regional development perspective	201
<i>Cliff Walsh</i>	

PART C DISCUSSANT PAPERS

8	Structural change: objectives, evaluation and incentives	233
	<i>Peter Forsyth</i>	
9	Evaluating policy changes: the economic and social dimensions	243
	<i>Glenn Withers</i>	
10	Delivering effective adjustment assistance	251
	<i>Peter Saunders</i>	
11	Issues in adjustment assistance	261
	<i>Andrew Stoeckel</i>	

PART D APPENDIXES

A	Brief for commissioned papers	271
B	Workshop program	275
C	List of participants	276
D	Speaker and discussant profiles	278

BOXES

4.1	Concern about the decline of regional Australia	112
6.1	Modifying reform to lessen adverse side effects	174
6.2	Addressing equity in tax design	176
6.3	Balancing efficiency and equity — some key considerations	189

FIGURES

4.1	Impact of distributional constraints	101
4.2	Interaction of reform and income redistribution	105
A5.1	Conditions of economic growth: an overview	156

6.1	First and second best policy in a two person setting	169
6.2	The social gain of a policy reform in a two person setting	185

Abbreviations

ACC	Area Consultative Committee
ASIC	Australian Standard Industrial Classification
BCA	Business Council of Australia
COAG	Council of Australian Governments
DEETYA	Department of Employment, Education, Training and Youth Affairs
EPAC	Economic Planning Advisory Commission
GBE	Government business enterprise
GDP	Gross domestic product
GST	Goods and services tax
IAC	Industries Assistance Commission
IC	Industry Commission
NAIRU	Non-accelerating inflation rate of unemployment
NATSEM	National Centre for Social and Economic Modelling
NCP	National Competition Policy
OECD	Organisation for Economic Co-operation and Development
PC	Productivity Commission
PMV	Passenger motor vehicles
RAC	Rail Access Corporation
REDO	Regional Economic Development Organisation
REDS	Regional Economic Development Scheme
TCF	Textiles, clothing and footwear

1 Introduction

Gary Banks

Adjustment and distributional issues are at the heart of the public debate on the future direction of microeconomic reform. The increased attention to the adjustment and social consequences of reform can be seen as a reflection of growing community concern about the process and implications of microeconomic reform, and of change more generally. These concerns are evident to anyone who discusses reform issues with a cross section of the community — the Productivity Commission’s current inquiry into the *Impact of Competition Policy Reforms on Rural and Regional Australia* being a case in point.

As the Productivity Commission observed in its first Annual Report (PC 1998), there is considerable disquiet in sections of the Australian community about the effects of change and a heightened sense of uncertainty about the future. People are questioning whether microeconomic reform has achieved its supposed gains. Some see the gains as inherently small, or not justifying the adjustment costs. There is a view that those adversely affected have not been compensated adequately. There is also scepticism about whether ordinary Australians are sharing equally with the ‘big end of town’ and dissatisfaction with how adjustment to change has been managed.

While such views contain a number of misconceptions about reform and its relative contribution to the ongoing changes in the economy, this groundswell cannot simply be dismissed as the product of ignorance. Key figures within the economics profession itself have raised similar questions and some have been highly critical of the policy reform approaches of the past.

Fred Argy elevated the debate in his 1998 book, *Australia at the Crossroads: Radical Free Market or a Progressive Liberalism?*, putting forward a number of challenging propositions for new directions in policy development. Wolfgang Kasper, who in 1980 published a book with the same principal title — though anticipating a different answer to Argy’s question — has strongly reaffirmed his contrasting views in an exchange with that author in a recent edition of the journal *Policy* (1998-99). The workshop afforded an opportunity to explore these and other views about the merits of different policy approaches to handling the adjustment and distribution challenges of microeconomic reform.

It should be emphasised that while there is obvious disagreement about some policy approaches, there is generally little disagreement (at least among economists) about *ends* — namely, higher living standards for Australians — or about the fact that these ultimately depend on the flexibility and productivity of our economy.

It is the political dilemma of microeconomic reform that, in raising the nation's productivity and average income levels, losses are inevitably incurred by some members of the community. The asymmetries in the incidence of costs and benefits of reform are, of course, well known as one of the major obstacles to reform itself. Australia, remarkably, has surmounted those obstacles pretty successfully since the early-1980s, but clearly they have never disappeared — and are again in the ascendant.

If resistance to change is not to prevent generally beneficial reforms from proceeding, it is clearly important that we properly address the concerns about reform.

An essential part of this task is to continue explaining to the community why reform has been undertaken, what the benefits have been and why further reform is necessary. The Productivity Commission has an important role to play in this regard. It is specifically charged with helping governments explain the whys and wherefores of reform.

The task should become easier as we move from projected to realised gains. While it is hard to disentangle the separate contribution of reform to changes observed in the economy, there is a growing body of evidence of substantial gains. It is broadly consistent with initial expectations. At the aggregate level, the unprecedented jump in multifactor productivity growth in the 1990s is difficult to explain other than as in part a consequence of the microeconomic reforms of the past decade or so (IC 1997d; Parham 1999).

The way reforms are evaluated and implemented is vital to achieving good policy outcomes. Policy choices need to be based on the best available information and analysis of the costs as well as the benefits of specific reform proposals — not just for particular groups, but across the wider community and economy. Understanding the social consequences of reform is part of this, and was a focus of the workshop.

The social dimensions of public policy have become more prominent in the work of the Commission as our inquiries and research reports have been extended from traditional industry assistance issues, to areas of social infrastructure like health or education. In these areas, effectiveness of service delivery (including access and quality) are just as central to performance as efficiency. Current inquiries into the gambling industries and broadcasting also clearly have inherent social dimensions.

The Productivity Commission's interest in adjustment and distributional issues is not new, having its origins in the work of its predecessors — the Bureau of Industry Economics, the Economic Planning Advisory Commission and the Industry Commission. For example, there is a long tradition, going back at least to the Industries Assistance Commission, of recommending phasing as a means of easing adjustment pressures and distributional impacts. This has been the standard approach to reducing border protection. Indeed, the Industry Commission's preferred profile of tariff reductions for Textiles, Clothing and Footwear and Passenger Motor Vehicles would arguably have involved smoother adjustment in this respect than the legislated outcomes (IC 1997b, 1997c).

There are other examples. In its report on private health insurance, the Commission recommended — on both efficiency and equity grounds — modifications to community rating based on age of entry. It proposed, however, that this change apply only to future entrants and that there be an initial grace period during which anyone could enter under the old rules (IC 1997a). In the area of water pricing, the Commission recommended increasing the price of water to better reflect the cost of supply. Recognising that irrigators would need time to adjust, the Commission also proposed an interim subsidy that would reduce progressively over time (IC 1992).

While the Commission's predecessors long struggled with the question of whether supplementary, selective adjustment assistance was warranted for particular industries or groups — and generally ended up favouring more generalised mechanisms of support — there have been important exceptions. Recent examples include, again, the Productivity Commission's 1997 TCF report, which recommended targeted support to improve the employability of workers in the industry, as well as assistance to depressed regions with concentrated TCF activity. Also, the draft report for the *Impact of Competition Policy Reforms* inquiry, has posed a number of questions for participants about the adequacy of existing adjustment measures (PC 1999).

Similarly, there is a range of work that has been undertaken on distributional and regional effects of reform, going back to the early empirical assessments of the incidence of import tariffs (as taxes) (IAC 1980) and including more recent studies on the distributional impacts of Government Business Enterprise reforms (IC 1996; Johnson, Cole and Davis 1996; Jomini et al. 1996), the labour market consequences of trade liberalisation (Murtough, Pearson and Wreford 1998) and other microeconomic reforms (IC 1998).

One of the central issues in developing better policy outcomes is the nature of the evaluative framework used to assess reform options. This raises some challenging questions. What decision criteria should form part of any evaluation of policy? To

what extent should governments, or those advising them, trade off efficiency gains from reform against equity, regional development or other considerations? How are any such trade-offs best handled? Should adjustment and distributional effects be considered for each proposed reform separately, or in the context of a wider set of policy changes?

Other key questions relate to design and implementation issues when dealing with the adjustment and distributive impacts of reform. Of course, governments already have a range of measures in place to help reduce adjustment costs and temper distributional impacts. The social security system provides a minimum level of income support for people displaced from their jobs. And generally available labour market programs provide complementary assistance with training and job search. A key issue, therefore, concerns the circumstances in which these general programs of support may be insufficient, requiring more targeted adjustment assistance.

Reform programs can also be designed or implemented so as to minimise adjustment costs. Various measures are available to achieve this end, such as phasing, broad-banding of reforms (to provide some offsetting beneficial effects) or watering down a reform program. Providing direct compensatory assistance to address adverse distributional impacts of reforms is another option. The GST debate has given this some prominence. Again, a number of challenging questions arise in the implementation of reform. What are the relative merits of these measures and when should they be used? Is direct compensation appropriate for some reforms, but not others (or for other sources of change)? What should be the decision rules? Can such assistance be efficiently and effectively provided?

Against this background, the Commission asked those preparing papers for the workshop to address three important questions, namely:

- Should governments approach the adjustment and distributional effects associated with market and policy-based changes differently or in much the same way?
- How should adjustment and distributional issues be dealt with in the process of evaluating specific policy changes?
- What approaches work best to support the adjustment process associated with implementing policy changes?

These questions raise many related issues. Many of them are complex and there are no easy answers. The Commission is publishing the workshop papers and discussion to facilitate wider public debate about these issues. The workshop will also help the Commission to clarify and further develop its thinking on these matters. To this end, our intention is to follow up with a research study setting out

where we have got to on some of the key issues. We intend to publish the results of this research by the end of the year. The workshop and subsequent research will also be used to inform the Commission's approach to current and future inquiries and its wider program of research.

The overview which follows this introduction provides a summary of the commissioned papers presented at the workshop, along with summaries of the discussants' papers and the roundtable discussion. The five commissioned papers, followed by the discussants' papers, are presented in full in parts B and C.

References

Argy, F. 1998, *Australia at the Crossroads: Radical Free Market or a Progressive Liberalism?*, Allen & Unwin, Sydney.

— 1998-99, Correspondence, *Policy*, vol. 14, no. 4, Summer.

IAC (Industries Assistance Commission) 1980, *Approaches to General Reductions in Protection: Tariffs as Taxes*, Information Paper No. 2, AGPS, Canberra.

IC (Industry Commission) 1992, *Water Resources and Waste Water Disposal*, Report no. 26, AGPS, Canberra.

— 1996, *Annual Report 1995-96*, AGPS, Canberra.

— 1997a, *Private Health Insurance*, Report no. 57, AGPS, Canberra.

— 1997b, *The Automotive Industry*, Report no. 58, AGPS, Canberra.

— 1997c, *The Textiles, Clothing and Footwear Industries*, Report no. 59, AGPS, Canberra.

— 1997d, *Assessing Australia's Productivity*, Research Paper, AGPS, Canberra.

— 1998, *Microeconomic Reforms in Australia: a Compendium from the 1970s to 1997*, Research paper, AGPS, Canberra.

Johnson, M., Cole, M. and Davis, L. 1996, *GBE Price Reform: Effects on Household Expenditure*, Industry Commission Staff Information Paper, AGPS, Canberra.

Jomini, P., Robertson, P., Greenfield, R. and Gregan, T. 1996, *Reform and the Distribution of Income: An Economy-wide Approach*, Industry Commission Staff Information Paper, AGPS, Canberra.

Kasper, W. 1980, *Australia at the Crossroads: Our Choices to the Year 2000*, Harcourt Brace Jovanovich, Sydney.

— 1998-99, Correspondence, *Policy*, vol. 14, no. 4, Summer.

Murtough, G., Pearson, K. and Wreford, P. 1998, *Trade Liberalisation and Earnings Distribution in Australia*, Industry Commission staff research paper, AGPS, Canberra.

Parham, D. 1999, *The New Economy? A New Look at Australia's Productivity Performance*, Productivity Commission Staff Information Paper, AusInfo, Canberra.

PC (Productivity Commission) 1998, *Annual Report 1997-98*, AusInfo, Canberra.

— 1999, *Impact of Competition Policy Reforms on Rural and Regional Australia*, Draft report, Canberra, May.

2 Overview

Workshop participants presented a range of views on policy issues relating to structural adjustment. This overview brings together the main points raised in the commissioned papers, the discussants papers and the general discussion. It is organised around the two workshop sessions and related core questions posed by the Commission in its brief to authors (appendix A).

Evaluating policy changes — the economic and social dimensions

Should governments approach the adjustment and distributional effects associated with market and policy-based changes differently or in much the same way?

Commissioned paper responses

Wolfgang Kasper and Cliff Walsh argued that, in most circumstances, it is impossible to distinguish between the specific consequences of policy and market-based sources of change. Kasper notes, ‘In a continually evolving, complex economy, it is not possible to attribute quantified consequences to one factor — such as a policy change ... a specific material consequence can be attributed to a cause beyond reasonable doubt only in exceptional circumstances, for example when a policy change was major, specific and stepwise’. Walsh made the point that disentangling the influences of market- and policy-induced change becomes even more difficult when policies are phased in over time.

It’s impossible to separate out government and market influences ...
Kasper p. 144

Walsh p. 222

Kasper’s view is that, because outcomes cannot be attributed to a specific cause, both market- and policy-influenced changes should be treated in the same way — that is, via the taxation and general social security systems, as well as through policies that facilitate adjustment. Malcolm Gray is also sympathetic to this way of handling changes in the

... so use tax and social security systems with some adjustment assistance.
Kasper p. 145;
Gray pp. 98–9

Walsh p. 221

Outcomes, not sources of change, matter.

Argy pp. 64–5

*Gray p. 99;
Savage pp. 172–73*

For policy changes, there is scope for governments to make changes ex ante.

Argy p. 65;

Savage p. 173

Gray and Argy — do governments have a moral responsibility?

Gray pp. 98–9

economy, but advocated special measures when the circumstances are unusual in respect of their scale and likelihood of occurrence, and can be clearly attributed to policy. Similarly, Walsh had an ‘exceptional circumstances’ provision in his treatment (discussed below).

Fred Argy also argued that, both in principle and in practice, governments should deal with market- and government-induced changes in broadly the same way. In principle because, if governments are concerned about social welfare, they should be concerned about the effects of both sources of change. In practice, the two kinds of changes often interact and have very similar effects. That view also emerged from Gray’s and Elizabeth Savage’s papers. Both of these authors, however, suggested that market-based changes can be separated and should be treated differently.

Argy and Savage differentiated between how the government should intervene when the cause is the market compared to when it is the government itself. Both authors observed that governments may not have appropriate information to intervene in response to market-based changes ex ante, so any intervention has to occur ex post. For government-induced changes, however, the intervention can (and should, according to Savage), be ex ante (that is, distributional considerations should be integral to policy design), although it may be desirable to respond ex post as well. Argy, however, made the point that this is more a practical than logical constraint for differentiating between the two types of change.

Gray and Argy added another dimension to their treatment of this question by referring to the moral responsibility of government. Gray looked at circumstances where special assistance is provided in the case of changes unrelated to policy — this is typically in response to natural disasters. Other changes in circumstances, with broader links to policy, such as exchange rate movements, do not usually give rise to responses beyond those available via existing redistributive mechanisms. By and large, people are expected to look after themselves within the framework of these mechanisms. Gray then explored the issue of whether policy reforms should be

treated in the same way. As Gray sees it, the crucial difference between reform and market-based changes is that reform is something the community, through its elected government, chooses to impose on itself. For this reason, society may be disposed to assume responsibility for the outcome in a way which differs from its approach to market generated pressures for structural change and adjustment. This is most likely to be the case when the impact of reform is large, difficult to anticipate, the losers are poorly placed to adjust *and the consequences can be clearly attributed to the reform.*

Argy suggested that special assistance may be justified where there is a ‘breach with long-standing traditions or legitimate expectations’. But as market and policy changes have similar effects in practice, he conceded that the ‘moral responsibility’ argument is difficult to sustain for policy changes.

Argy pp. 64–5

Walsh saw no moral responsibility in relation to reform. He argued investments (whether in shareholdings or in human capital) are made in the knowledge that policies, like market conditions, can change — it’s all part of the investor’s risk. To compensate for policy changes, but not for market-induced changes would be like ‘... punters at the races having losing pre-race bets repaid if the stewards changed the start-finish line just before the race because of an immediate pre-race downpour, but not if the downpour occurred during the race’.

Walsh — no moral responsibility linked to reform.

Walsh p. 221

Notwithstanding this, Walsh drew a practical distinction between market-based and policy-based changes. As he sees it, policies are changed in a transparent process involving debate as to whether the reform should go ahead or not and, in this context, the distributional aspects of policy-induced change may need to be handled with some care. In contrast, market-based changes simply happen according to commercial judgements. This is similar to Gray’s ‘society chooses to impose reform on itself’ argument. But, from this position, Walsh did not advocate compensation for losers unless there are *truly exceptional circumstances* (in this way he aligned himself with Gray). While Walsh did not specify

Distributional aspects of policy-induced change may need to be handled with more care ...

... only in exceptional circumstances may compensation be justified.

Walsh pp. 224–8

what might constitute ‘exceptional circumstances’, he did recognise the ‘just compensation’ clause in the Constitution and the quasi-constitutional status of fundamental changes to taxation and social security. He argued that evaluation efforts should be concentrated on what are agreed to be ‘exceptional circumstances’.

Discussants’ views

Forsyth argued that in some cases the distinction between market and policy changes is very clear.

Forsyth p. 240

Peter Forsyth argued that Kasper’s claim that policy- and market-induced changes can’t be distinguished is an ‘extraordinary position to take’. While it may be difficult to distinguish between these broad groups of changes (as many changes involve a combination of both elements), he considered that in some instances the two can be distinguished very clearly. Forsyth used the decision to build the Citylink expressway in Melbourne as an example. He argued that this decision could have been made differently; it was not the inevitable consequence of market-based changes. Forsyth claimed that a government resuming land for a project cannot deny responsibility.

Attitudes may vary according to the type of change ...

... and there are practical differences.

Forsyth p. 240

Forsyth also noted that attitudes towards market- and policy-induced changes can be quite different — societies may be willing to accept losses from market-based changes (because they are regarded as inevitable), but may regard policy-induced losses as being unfair (because they could have been avoided). He also identified an important practical distinction between market- and policy-based changes: the latter require political decisions for them to go ahead, while the former do not. The likelihood of having to provide compensation is increased in the policy-related case (whether compensation is paid may determine if the change happens or not), whereas market-based changes occur regardless of whether the losers are compensated.

Glenn Withers likened the distinction between policy- and market-based changes to the difference between ‘murder’ and ‘manslaughter’. Policy changes are deliberate, clear and transparent decisions of elected individuals. Market changes are decentralised, indirect and diffuse — there is no-one to blame. As such, Withers suggested that policy changes may have a different moral and practical rationale for justifying compensation. Having said that, however, he argued that compensation for policy changes need not be universal but rather is appropriate for ‘innocent victims’ of change where the outcome of a deliberate decision of government threatens an individual’s livelihood.

Because policy changes are a deliberate action by governments, there is an expectation that losers will be fairly treated.
Withers p. 247

General discussion

There was some discussion of the ‘commonsense’ distinction between policy and market-based changes — governments are directly responsible for one but not the other. In this context, it was observed that the notion of what is fair, and what is not, might be explained by how direct the relationship is between the policy change and its consequences. Michael Keating provided some examples to illustrate this point. If the government tightens monetary policy and some builders go broke, the case for special assistance for the losers would be fairly weak because the relationship between the change and the consequence is fairly indirect, and other factors (such as financial imprudence or excessive gearing) may be involved. On the other hand, if the government were to deregulate the taxi industry, the case for assisting the losers (taxi plate owners) would be stronger because the relationship between the policy change and the consequences is more direct. Also, the affected parties can be more readily identified.

If consequences can be clearly attributed to a policy change, governments may be expected to compensate losers.

Others commented that governments should address market failures affecting the process of adjustment, irrespective of the source of change. One suggestion was that governments shouldn’t wait until there is reform and associated structural change to correct a market failure.

If correcting market failures, the source of pressure for change is irrelevant.

How should adjustment and distributional issues be dealt with in the process of evaluating policy changes?

Commissioned paper responses

A range of views.

The authors presented a range of views on how adjustment and distributional issues should be dealt with when evaluating policy changes.

Treat adjustment and distributional impacts with 'benign neglect', Kasper pp. 145–6

Kasper's short answer was that adjustment and distributional issues should be treated with 'benign neglect' when evaluating specific policy changes. He argued that there is simply no way of knowing all adjustment and distributional impacts in a complex and evolving economic organism. It is normally not feasible to differentiate ex ante between different classes of adjustment costs and attribute them to specific policy measures. 'Productivity-promoting reforms ... should not be hindered by inconclusive, drawn-out political debates about equity or regional impacts, most of which are unknowable and unprovable'.

... consequences are softened by the tax and social welfare systems.

Kasper pointed out that, when adjustment and distributional impacts occur in concentrated form, the consequences are usually softened by the tax system. Remaining impacts on private citizens are best compensated via the social welfare safety net.

It is difficult to assess the impact of change. Walsh p. 204

Walsh commented that analysing policy changes using a comparative static framework can be highly misleading, since many adjustment and distributional issues have a crucial dynamic element. In a world of rapid technological change, he considered it 'something of an oddity' that measures of benefits (and costs) of reforms are restricted to the 'one-off' consequences of resource allocation and that so little attention is paid to assessing the dynamic effects (such as contribution to the rate of innovation, the adoption of new technologies and welfare consequences). Within the existing evaluation and modelling methodologies, Walsh did not provide a simple answer to the question of how to evaluate the impacts of specific policy initiatives. But, 'the difficulties associated with evaluation of the consequences of change, either for overall productivity and growth, or for

But that isn't a good reason not to try ...

distributional outcomes, aren't a good reason for not attempting to evaluate them'.

In Walsh's view, policy decisions could be improved if more information was provided, especially about the distributional impacts of proposed changes. The geographical location of gainers and losers, and the consequences for communities, are also key pieces of information which should be provided to policy makers. The Productivity Commission, in his view, should be devoting much more of its research effort to building dynamic modelling frameworks.

... and better information improves policy decisions.

Gray recommended that adjustment and distributional issues should be taken into account in any decision to adopt reform. He suggested that, in many cases, preliminary work on the distributional implications of reforms may suggest no need to look further (in other words, the changes may lie within the bounds of the day to day perturbations of economic circumstances and can be handled by existing redistributive mechanisms). But, 'this needs to be clearly established, not presumed'. Where distributive effects are likely to be substantial, identification of their incidence and scale is an important first step in an iterative process of refining policy design. Gray noted that sometimes comfort is sought in the proposition that the problem of allocating resources efficiently can be separated from equitably distributing them, but 'this proposition holds only when redistributions may be effected costlessly'.

If preliminary work suggests distributional impacts are substantial, then identification of their incidence and scale is important.

Gray pp. 102–3

On adjustment costs, Gray acknowledged that these are difficult to estimate. However, comparative static modelling can generate estimates of some of the parameters of change, which can be combined with other information to indicate orders of magnitude. Other potential sources of information include reform experiences in similar countries, assessments by affected groups and longitudinal data.

While adjustment costs are difficult to estimate, there are some options.

Gray p. 107

Both Argy and Savage expressed the view that distributional issues should be an integral part of the design and evaluation of economic reform proposals. For Argy, the availability of a basic social safety net, and existence of favourable trickle down effects of growth-oriented reforms, does not justify an 'efficiency only' approach to assessing reforms. He

Argy and Savage argued that distributional issues should be an integral part of the design and evaluation of reforms.

acknowledged, however, that a great many cases do not lend themselves to any reasonable ex ante identification of either winners or losers — such as with economy-wide reforms like financial deregulation. In such cases, ex post interventions to modify distributional outcomes need to be considered (see section on delivering effective adjustment assistance).

But, when ex ante assessments are too difficult, use ex post mechanisms.
Argy pp. 59–60

If adverse welfare impacts occur, then modify policy at the design stage.
Savage pp. 165, 173

Savage argued that the application of first-best assumptions to complex policy reform questions often leads to inefficient and inequitable outcomes. In her view, policy makers should identify the ‘welfare impacts of changes to the distribution of resources in society *when policy reforms are designed*’. She observed that, ‘It is far from best practice to introduce a policy change that may worsen efficiency and inequality, then to seek to address some adverse impacts ex post’. Hence, the separation of equity and efficiency considerations is not defensible. Instead, when changes to individuals’ welfare are induced by government policy, the government should modify the policy to mitigate adverse impacts.

Assess each reform individually or as part of a package?

Distributional impacts of reform should not be examined in isolation.
Argy pp. 64, 82;
Gray p. 107;
Walsh p. 222

Savage favoured assessment on a reform by reform basis.
Savage pp. 175–7, 192

Most authors thought related reforms should be evaluated as a package. Argy stressed that, in assessing distribution effects, governments should, where possible, ‘look at reforms not in isolation but as an integral package’. Gray argued that evaluations should deal with the reform as it is proposed to be implemented. If a reform is part of a package, the whole package should be evaluated, because there may be important interaction effects (different policies within the package may ameliorate or redistribute adjustment costs). Walsh was of a similar mind, arguing that it is necessary to evaluate the full sequence of reforms because those who are relative losers at one stage could become relative winners at another. In contrast, Savage favoured identification of distributional effects for each and every policy option. This information could then be used to modify the specific reforms to lessen distributional side-effects.

The efficiency/equity trade-off

In discussing this issue, authors worked through two questions: What should be the appropriate trade-off between efficiency and other objectives? And, how can this information be incorporated into the policy evaluation framework? The authors were generally of the view that the appropriate efficiency/equity trade-off should not be decided by economists. This was a question for the community to decide. Nevertheless, most felt that economists had a real role to play in providing information to help the community understand the nature and implications of this trade-off and facilitate more informed decision making.

Argy said ‘no economist can lay down firm rules on trade-offs involving efficiency, employment and equity. ‘Economists can only help politicians make choices by assessing the distribution effects and quantifying the efficiency or employment benefits’. However, he suggested that, in some instances, there may be simple resolutions to the efficiency/equity trade-off. For example, if adjustment costs and distribution effects of a change are small and the potential efficiency gains are large, it might be appropriate to simply ignore the former. Conversely, if the adjustment costs are high and the long term distribution effects highly regressive (but efficiency gains are small or uncertain), it is probably best not to proceed with the reform.

Argy acknowledged, however, that most reforms involve more complex sets of circumstances and are not, therefore, as easy to resolve. In such cases, he suggested ‘reform dilution’ (that is, modifying a reform to lessen its impact or exclude elements with uncertain side-effects), but noted that compromises may produce second best outcomes for either efficiency or equity or both. However, they may well be optimal for social welfare.

Gray stated that policy evaluation and design cannot avoid judgements about trade-offs. He suggested that policy advisers can obtain some guidance on what might be the appropriate trade-off from a number of sources including: the community’s reaction to, and treatment of, similar situations in the past; safety net mechanisms and their associated

Appropriate trade-offs are not for economists to decide ...

... but they can help the community to better understand the implications of particular trade-offs.

If adjustment and distribution effects are small and efficiency gains large, the former can be ignored.

Argy pp. 70–3

But, most reforms involve more complex trade-offs.

A number of sources provide guidance on appropriate trade-offs.

Gray p. 113

eligibility criteria; and the principles underpinning emergency relief arrangements and the specification of triggers for assistance. In Gray's view, the major way for analysts to add value is by clearly identifying and communicating available trade-offs.

Conservative reform strategies can lead to rejection of worthwhile reforms.
Gray p. 113

Gray warned against taking a conservative approach to microeconomic reform — which he interpreted to mean rejecting reforms unless the potential efficiency gains far outweigh any adverse social or distributional consequences. In his view, this could lead to the rejection of many worthwhile reforms, particularly since costs are often easier to identify and quantify than benefits.

Obviously regressive impacts of reform suggest more than existing tax-transfer mechanisms are required.
Walsh p. 206

Walsh argued that while economists are neither uniquely, nor generally, well equipped to make distributional judgements, '... we'd surely agree that obviously regressive impacts of reforms ... establish an a priori case for schemes of interpersonal redistribution that might go beyond relying on existing tax-transfer mechanisms to do the job'. He also observed that 'If there's one clear message from decades of theorising about welfare effects, it is that the ... assumption that efficiency and distribution effects can be separated, and the latter can be left to be corrected by 'the distribution branch of the public household', is pure fiction, conceptually as well as practically'.

Important to make underlying judgements explicit.
Savage p. 184

Savage argued that ascertaining whether a policy results in a social gain entails modelling the welfare impacts of the policy and balancing the conflicting goals using an explicit ethical position to trade off gains and losses. According to Savage, 'Making this judgment explicit determines how 'demonstrably large' efficiency gains need to be to result in a social gain when a policy has adverse distributional outcomes'.

History and international experience suggest a bias in favour of growth.
Kasper p. 125

Kasper suggested that a bias in favour of growth (efficiency) seems preferable from historic and international experience, because 'sustained productivity growth makes it possible and likely to advance the life opportunities of the poorest 10 or 20 per cent, whereas a preference for redistribution often undermines economic growth, so that the poorest 10 or 20 per cent are worse off in absolute terms than under a growth

strategy'. Moreover, Kasper observed that, 'The public debate is often cast in terms of a discussion of efficiency *versus* equity, frequently on the (wrong) assumption that one can have economy-wide productivity growth without 'iniquitous', 'socially unjust' challenges to existing socioeconomic positions'. In his view, 'No form of collective action could ever protect people from change, even if the community were prepared to sacrifice all economic growth!'

Kasper pp. 134–5

Treatment of winners and losers

Gray was not in favour of formal methods for describing the social welfare function such as distributive weights. He argued that they are perhaps useful for indicating the range of alternative community valuations of a given set of outcomes, but such methods are sensitive to the choice of weights. Indeed, it is difficult to justify simple rules such as weighting losers interests more highly, for losers may be rich or poor as may winners, and the significance of the loss or gain proportionately small or great. Gray suggested drawing on information contained in existing programs (such as their objective statements and associated requirements) to provide a broad indication of the appropriate trade-off — then gathering further information through an iterative policy formulation process. Argy's view was that any cost-benefit analysis of a policy proposal should have an 'implicit' utility weighting in favour of low income groups. Kasper argued that attaching higher weights to the (organised) interests of losers than to the (often unorganised) interests of the winners from policy reform is unfair and can have deleterious side effects (such as moral hazard) and will 'delegitimise growth policies'.

Formal methods such as distributive weights can provide some guidance, but assessments sensitive to choice of weights.

Gray p. 113

Argy p. 49

Kasper p. 146

Of the five authors, Savage saw the most merit in the use of distributional weights. She argued that a policy can only be properly evaluated when the gains and losses to all individuals are identified. This information could then be used to determine social welfare gains and losses by ascertaining 'the sign of the weighted sum of individual gains and losses, where the weights depend on the position of each individual in the distribution of welfare and the ethical position on inequality'. According to Savage, there is no

Distributional weights can be derived from examining society's ethical position on inequality.

Savage pp. 181–3

justification for placing a higher weight on losers than gainers. Rather, relative weights should be determined by an individual's relative level of welfare.

Onus of proof

Onus of proof should rest with the government and/or the advocates of reform.
Argy pp. 66–7;
Savage pp. 188–9

Responses varied widely as to whether the onus of proof in relation to arguing the case for or against reform should rest with the advocates of reform or, as with national competition policy, the defenders of the status quo. For example, Argy observed that placing the onus of proof on advocates of reform could hold up important reform while the opposite could mean that distributional effects received inadequate attention. In his view, if a government, with all its enormous authority, resources and marketing advantages, cannot clearly and convincingly show how a reform will make the great bulk of Australians better off within a reasonable period of time, then it probably means that the distribution effects have not been well thought out. Savage thought that the onus of proof should always rest with the advocates of reform.

Burden of proof should rest on defenders of the status quo.
Kasper p. 144

Kasper disagreed, placing the burden of proof squarely on those who seek to maintain the status quo. He emphasised the importance of flexibility in an economy to enhance efficiency and growth and noted the difficulty of proving direct material harm from policy change, but stressed that the burden of proof should be on the claimants, not government agencies.

Discussants' views

The 'emperor has no clothes' — gaps in the neoclassical framework for dealing with adjustment issues.
Withers pp. 243–4

Glenn Withers, while commending the authors on their efforts to grapple with these difficult structural adjustment issues, expressed disappointment at the state of the economics profession in the area of adjustment. Structural adjustment remains a category of policy measures still searching for an analytical framework — 'the emperor has no clothes' in this area. According to Withers, the papers exposed the comparative static framework as being unspecific beyond some broad compensation criteria, incapable of expressing the dynamic nature of adjustment and unable to provide any insight to how adjustment decisions are made at the firm level.

Withers, commenting on the lack of attention to dynamic influences (with the exception of Kasper), noted that the authors focussed on distributional consequences of reform and ignored adjustment costs per se. Adjustment costs were interpreted as being equal to, or a sub-set of, distributional concerns, but not a part of the efficiency calculus itself. Withers argued that including a real-time adjustment path in the analysis of a policy reform can substantially affect the resulting efficiency estimates. It is also important to know what the adjustment path looks like. Withers suggested that the process could be improved by better development of distributional information and adjustment cost information to enrich comparative static presumptions.

Lack of attention to dynamics ... authors focused on distributional issues; adjustment costs were largely ignored.

Putting real time on the adjustment path and knowing what it looks like is important.

Andrew Stoeckel recommended the use of dynamic models to measure adjustment costs, noting ‘the Commission should go down this route if it sticks to modelling to at least see how adjustment costs stack up against efficiency gains’. And, ‘... some attempt at quantification of policy change is unavoidable if a scientific approach allowing repeatability and testing of ideas is to be adopted in looking at structural change’.

Stoeckel suggested the use of dynamic models.
Stoeckel pp. 265–6

Peter Forsyth observed that, if structural changes are to be evaluated, the objectives need to be set out. He suggested adding fairness — what he called ‘the uninvited guest’ because economists are so uncomfortable with it — to the standard policy objectives of efficiency and equity. Forsyth argued that many structural changes will meet efficiency and equity tests, but will still be opposed on fairness grounds. Whilst acknowledging that there were no generally accepted criteria as to what constituted fairness, Forsyth observed that fairness is ‘perhaps a concept applied more to the way a process is carried out than to the outcomes of the process’. He suggested that, while economists may not determine what fairness is themselves, they do have a role in designing alterations to policies so as to minimise the cost in terms of equity and efficiency of meeting the constraints of fairness. Forsyth also raised the issue of whether consideration should be given to specific groups or regions when evaluating policy changes.

‘Fairness’ should be added to the list of objectives.
Forsyth p. 233

Forsyth pp. 235–7

Distributional consequences of reform should be considered as part of the main game, rather than as an add-on.
Saunders pp. 251, 253

Peter Saunders' considered that the papers did not reflect well on the ability of economists to provide useful and non-controversial advice to government on distributional issues. He commented on the contrast between the 'theoretical sophistication' with which questions of efficiency and growth are handled and the 'simplified' way in which issues of inequality and redistribution are handled (Savage's paper being the exception). Saunders also considered that the papers highlighted the limitations of trying to consider the distributional consequences of structural change as an 'add-on' rather than being part of the 'main game'.

Distributional issues should be part of the product, not the sales drive.

Saunders commented that, since the emphasis should be on community well-being, 'distributional questions have to be seen as an *integral* part of policy and built in at the design stage — as part of the product not just part of the sales drive'.

General discussion

Three main themes emerged from the discussion of issues related to the evaluation of policy changes:

- the inadequacy of the standard neoclassical framework in dealing with adjustment and distributional issues;
- the role of economists in policy making; and
- factors that should be taken into account when evaluating policy changes.

The inadequacy of the standard neoclassical framework

Inadequacy of the comparative static framework for dealing with dynamic issues ...

There was some discussion about the inadequacies of the standard neoclassical framework in handling dynamic issues relating to the adjustment and distributional impacts of reform. It was generally agreed that more could be done by economists to provide a better understanding of the process of adjustment and the distributional consequences of reform. Suggestions included explicitly modelling adjustment paths to take account of transitional adaptations by firms, workers and regions, and incorporating assessments of the

distributional incidence of reforms to provide more information to assess policy options.

A number of participants commented that the overall economic benefits of reform are often understated because dynamic effects are not adequately addressed. For example, the impact of reforms on institutional arrangements and incentives for innovation and risk taking need to be more fully explored. Des Moore noted that most reforms involve the breaking down of protectionist or restrictive practices which are inherently inequitable. However, the potential improvements in equity that result are frequently misunderstood and overlooked. Reform proposals should therefore be accompanied by an explanation of the social as well as the economic benefits. Gary Potts suggested that more effort needs to be devoted to explaining the wider benefits of reform (potential benefits as well as realised — looking back over the past 10 to 15 years) including comparisons with the counterfactuals of more limited (or no) reform.

... because dynamic benefits aren't captured, economic benefits are understated.

Reforms may also enhance fairness and improve equity.

The role of economists in policy making

Participants were generally of the view that the role of economists and other analysts is to point out the choices, not to develop master plans or blueprints for society. Some discussion took place on how economists could gain a better understanding of community preferences on difficult issues — such as how to handle the trade-off between equity and efficiency. Walsh expressed some concern about efforts by economists to deduce appropriate distributional weights by looking at actual policy outcomes. In his view, this could result in an inconsistent and incoherent picture — simply the average of a set of bad decisions made by politicians. There was also some discussion of the pros and cons of using forums such as community focus groups to gain an understanding of community preferences on different issues.

Economists' role is to highlight the relative merits of different options, not to provide a master plan for society.

Evaluating policy changes — the factors to consider

‘Fairness’ is important to the community.

There was some discussion about the need to take account of factors other than efficiency and equity when evaluating policy changes. While a number of factors were mentioned (including consideration of special groups and regions), the focus of the discussion was on adding ‘fairness’ to the equation. It was generally agreed that ‘fairness’ was important to the community and that it also mattered politically. One participant commented that the changes occurring in this country (and others) cannot be assessed in pure economic terms, ‘there is a fairness issue involved, there is an equity issue, and there is a politically pragmatic issue to deal with’.

Different views on what constitutes fairness.

Differing views were expressed about the practical meaning of fairness in economic policy. Argy considered fairness to be about legitimate *process* — conducting policy transparently, honestly and with adequate consultation and participation. Kasper reiterated the important distinction made in the social science/philosophy literature between procedural justice (non-discriminating rule of law) and outcome equality — which is quite different. Saunders suggested that fairness and equity could, in general, be used interchangeably.

The importance of public perceptions was also recognised, with a number of participants observing that, to gain community support for a program of microeconomic reform, policy changes have to be seen to be fair.

Should taxi plate holders be treated differently to shareholders in a TCF or PMV company?

One participant suggested that to remove taxi plate licences overnight would be unfair as well as a politically bad option. Walsh, however, questioned why taxi plate owners should be treated any differently to say shareholders in a PMV or TCF company. All players know that there is a risk that the policy environment will change. A counter comment was that, while in theory it is not possible to distinguish between a taxi plate owner and shareholders in a TCF firm, the real point is more pragmatic — about the political environment in which change is to be implemented.

Delivering effective adjustment assistance

What approaches work best to support the adjustment process associated with implementing policy changes?

Commissioned paper responses

A wide range of views were presented on the case for providing special compensation (over and above that available through the tax/transfer system).

- Kasper was strongly opposed to special compensation, ‘... policy makers committed to the common good and long-term productivity growth should be extremely cautious about any form of compensation’. He argued that the notion that governments should compensate for the consequences of policy changes is ‘a byproduct of neoclassical welfare economics’ which is ‘based on a comparative-static lifeless nirvana that has little to do with a complex, continually evolving reality!’ According to Kasper, ‘no one ... can have the knowledge to calculate ‘proper’ compensation, because the transient gains and losses cannot be known or measured’.
- Walsh agreed with the ‘no compensation’ principle, other than in exceptional circumstances. He said that ‘with the tax/transfer system as a basic redistributive mechanism cum social safety net, it’s not obvious that any other context appropriately should involve ‘compensation’ of losers from policy-induced changes — except that good regional policies, good lifelong education and training policies and much else besides would make coping with change much easier — regionally and in industry specific circumstances’.
- Gray suggested some circumstances where the community may wish to provide special compensation for policy changes including: the impact being large and difficult to anticipate; the affected group being poorly placed to deal with the consequences; and the consequences being clearly and closely associated with the reform.

... a wide range of views on compensation.

Kasper recommended extreme caution in the area of compensation. Kasper pp. 140–1

Walsh said only compensate in exceptional circumstances ...

... but saw a role for education and training policies. Walsh pp. 221, 226

Gray identified some circumstances where compensation may be warranted. Gray p. 99

Argy identified a number of circumstances which may warrant adjustment assistance or compensation. Argy pp. 62, 82

- Argy, while recognising some practical difficulties associated with providing compensation and targeted adjustment assistance, also suggested cases where compensation might be feasible. Such cases include: structural reform shocks which have a disproportionate and substantial economic and employment effect on a particular region which is already disadvantaged or vulnerable; when those hurt by the shock are already relatively poor or disadvantaged; when the benefits accrue wholly or predominantly to the rich; the reforms are policy-induced and represent a breach with long standing traditions or legitimate expectations. Argy made the point, however, that ‘... it does not follow that every individual reform which has a significant distribution effect should be accompanied by adjustment assistance or targeted compensation’.

Savage argued that modifying the reform ex ante reduces the need for compensation. Savage p. 191

- Savage saw only a limited role for compensation. Her argument was that, if adjustment and distributional consequences of reform were addressed at the policy evaluation and design stage (for example, by modifying reforms appropriately), there would be little need subsequently to address adverse welfare impacts through ex post compensation measures.

Compensation is far from straightforward — there are numerous problems. Kasper pp. 141–4

Each of the authors acknowledged that there are problems associated with providing compensation. Kasper said that there are ‘numerous fundamental and practical problems’ such as — how do you determine what, and how much to compensate for? If compensating for policy change, should compensation be provided for inaction and non-reform? What constitutes a benefit or loss? Should impacts of partial reforms be measured disregarding earlier or subsequent reform? What time horizon should be used to measure costs/benefits? Kasper claimed that the problems seem intractable. ‘The decision rules and criteria for using tax resources to compensate certain groups cannot be known. If others advocate or demand compensation schemes they must provide practical solutions’.

In similar vein, Walsh identified several ‘tricky issues’ relating to evaluating the level of compensation that might be paid including: the dynamic circumstances of change and the inherent inadequacy of comparative static models, which only capture one-off benefits of resource reallocation rather than long-term impacts on innovation and growth, thereby trivialising the gains from reform; information on distributional impacts often is not provided or, where available, covers comparative static impacts rather than dynamic changes in opportunities; and the value of existing property rights is changed by the announcement effects of possible reform — at which point should values be evaluated?

*Walsh identified several ‘tricky issues’ in determining the appropriate level of compensation.
Walsh pp. 226–7*

A number of the authors also mentioned the problem of identifying winners and losers — a difficult task, although there is some recognition that it is easier for some reforms than others. Argy acknowledged that ‘a great many cases will not lend themselves to any reasonable ex ante identification of either winners or losers’. Winners are typically very diffuse or uncertain and benefits may only impact over time. Both Argy and Gray acknowledged the difficulty of taxing the winners from reform. Gray made the point that the existing redistribution mechanisms automatically provide some relief to those disadvantaged by reform and levy some taxes on those advantaged. He argued that attempts to tax winners are both practically difficult and may be seen as an inappropriate expropriation of private property rights.

*... winners and losers not easy to identify.
Argy p. 60*

Rent seeking behaviour and moral hazard problems were also discussed by Kasper, Gray and Walsh. The need for caution when compensating to buy off resistance to reform was noted by several authors. Walsh, for example, suggested that where policy-induced changes are clearly at the heart of the political pressures, it is not distributional equity that drives whether, or how much, compensation is paid, but rather the (potential) clout of the affected groups. He also argued that the supply of compensation creates its own demand. Gray stated that, if politically driven compensation is required, it should achieve its primary objective of removing the political blockage to the implementation of the reform and that the mechanism should deny the group blocking the reform further

*Actions directed at buying off resistance to reform need to be carefully assessed.
Walsh p. 225*

*Where provided, such compensation needs to build commitment for change and promote desired outcomes.
Gray pp. 108–9*

opportunity to make demands. He suggested that compensation should be made available in a way that gives the blocking group an interest in seeing the reform proceed, preferably attaching conditions such as the achievement of certain benchmarks.

The most appropriate form of compensation depends on the circumstances of the losers.

Argy pp. 67–8

Walsh said that if assistance is provided, it might best be delivered at the regional level.

Walsh p. 223

Argy suggested that the most appropriate form of compensation depends on the circumstances of the losers. For example, for displaced workers, compensation could take the form of job search, retraining and mobility assistance, while consumers faced with higher prices for infrastructure services (arising from the deregulation of public utilities) could receive vouchers, direct social security supplements or special exemptions. Walsh suggested that, if compensation or structural adjustment assistance were to be provided, ‘it might best be delivered at a region-wide level for agreed purposes supported by realistic strategic plans for the region, rather than to specific businesses or communities or groups of people directly affected by change’. He saw improved education and training and retraining services as being a particularly valuable target for regional support.

Guidelines to promote ‘efficient and effective’ compensation.

Argy p. 67;

Gray p.110

Some of the authors suggested that, if compensation is provided, some clear rules are required. Argy outlined some conditions to promote the provision of ‘efficient and effective compensation’. They include: that the losers can be identified so that the benefits are not wasted; that the method of compensation is transparent to ensure accountability; the administrative costs are low relative to the compensation payments; the form of compensation does not generate too many byproduct distortions; and the compensation should facilitate adjustment rather than provide passive support. Gray also outlined some principles to lessen the downside of providing compensation — including that it be paid in a form, or subject to conditions, that encourage individuals to move out of a disadvantaged group.

The role of phasing and preannouncing in the adjustment process

The five authors agreed that phasing and preannouncing reforms have a role to play in easing the adjustment burden of reform. For example, Kasper wrote that, ‘The adjustment burdens of citizens and firms can and should certainly be eased by reforms that are pre-announced, well explained and gradually implemented’.

Phasing and preannouncing reforms can ease adjustment burdens. Kasper p. 151

However, Kasper also recommended that governments avoid inconsistencies and back-tracking, such as tariff freezes, as this reduces people’s ability to frame sensible strategies for the future, and increases adjustment costs.

But back-tracking will increase adjustment costs. Kasper p. 151

Gray observed that by allowing people more time to adjust, community resistance to reform could be reduced. But he also pointed out that phasing postpones the realisation of the full benefits of reform and, in any case, phasing is a relatively blunt policy instrument which does not necessarily reduce the need for other forms of adjustment assistance.

Phasing postpones the realisation of the full benefits of reform ...

Gray, Argy and Savage recognised that a successful phasing strategy depends on the type of reform. Gray used the example of tariff reductions as a policy change suited to phasing, whereas replacing a wholesale sales tax with a GST is an example of a policy change needing immediate implementation. Savage argued that the effects of phasing need to be modelled and the net benefits compared to alternative implementation methods as a way of deciding whether to phase in a reform or not.

... and it is only suited to some reforms. Gray pp. 114–16

Benefits of phasing vs alternatives need to be assessed. Savage p. 193

As with phasing, preannouncing reforms make policy changes more predictable, which is a primary function of policy, according to Kasper. Gray, Savage and Argy agreed. However, Gray saw some danger in preannouncing; namely: the delay in benefits invites lobbying for the status quo (this also applies to phasing, although a preannouncement strategy delays the benefits of reform more markedly); and ‘excessively’ delaying reforms may exacerbate adjustment problems. For example, if consumers know a preannounced reform will reduce the price of a consumer durable, they will delay purchasing that good until the reform is implemented,

Preannouncing aids decision making by lessening uncertainty ... Kasper p. 147

... but it is not without problems. Gray pp. 114–16

causing ‘... a potentially costly ramp down and up in production’.

Broad-banding as a policy response

Benefits from packaging reforms ... lessening the need for compensation.

Argy pp. 68–9

Walsh p. 222

Gray p. 117

Implementing a number of reforms as a package (‘broad-based’ reforms or ‘log-rolling’) is another implementation strategy which received support from most authors. Argy stated that ‘Log-rolling ... is one way a government can be seen to be making a genuine attempt up front to spread evenly the costs and benefits of economic reform’. He suggested log-rolling where compensation is not feasible or desirable. Walsh noted that ‘sequential policy-induced reforms imply that those who are relative losers at one stage can become relative winners at another (and vice versa)’. Gray argued that, by spreading the costs and benefits, packaging reforms reduces the need for compensation of all kinds. Gray also maintained that implementing complementary reforms increases the flexibility of the economy, thereby reducing adjustment costs. Such packaging can generate benefits beyond those available from a piecemeal approach to reform.

Some provisos on reform packaging. Kasper pp. 146–7

Walsh p. 223

Savage p. 192

While broad-based reforms can help ease adjustment costs, the authors included some important provisos. Kasper dismissed the optimal sequencing literature as unrealistic and advocated reform whenever it is feasible. Walsh expressed concern that doing as much as you can all at once is neither practical nor desirable, since it can cause confusion about the consequences of reform among businesses and individuals and may prove counter-productive. As with her cautionary note in regard to phasing, Savage preferred the effects of a broad-based approach to be modelled against alternatives in order to evaluate whether or not a greater social gain would be achieved.

Reform dilution

‘Reform dilution’ (watering down reform) was another implementation strategy advocated by both Savage and Argy. Savage argued that there was a strong case for modifying a proposed policy change where the expected gains are concentrated at high welfare levels and the losses at low welfare levels. Argy noted that, while it is better to look first for win/win solutions, if they are not available or useable, it is legitimate to turn to compromises as a last resort. He argued that, although compromises may produce ‘second best’ outcomes for either efficiency or equity or both, they may well be optimal from the point of view of community welfare.

Reform dilution — another alternative to compensation. Savage pp. 191–2; Argy pp. 70–2

Ex post adjustments

A number of authors (Argy, Gray and Savage) saw a role for ex post adjustments to policy, to take account of new information (for example, about the effects of adjustment shocks) and lessons learnt as part of the reform process. Argy argued that there was a legitimate role for ex post social smoothing as a response to the practical difficulties associated with applying ex ante forms of social smoothing. He suggested that governments could proceed with reforms which clearly improve efficiency and then review the social outcomes periodically (say every 3 to 5 years) using a broad range of social indicators. To create a climate conducive to economic reform, Argy recommended that the ex post redistribution strategy be spelt out in advance (that is, at the same time as the reform program is announced). Argy recognised, however, that if governments were to rely heavily on ex post social smoothing, it would be important to have a consistent implementation framework, so as to avoid ‘political ad hocery’ and to build in various safeguards against ‘government failure’.

Scope for ex post social smoothing to promote better outcomes. Argy pp. 73–4, 83

Discussants' views

Compensation mainly about handling equity and fairness issues. Adjustment assistance primarily a response to market failures. Forsyth pp. 238–9

Peter Forsyth considered it useful to draw a distinction between compensation and adjustment assistance, since they address different issues — compensation primarily addresses equity and fairness aspects, whereas adjustment assistance aims to lessen the costs of adjustment by tackling market failures. Whether compensation and/or adjustment assistance is considered appropriate depends on the position taken. If an efficiency only position is taken, there is no reason to compensate, as it will detract from the gains from change. However, there may be an argument for providing adjustment assistance. Under the equity and efficiency position, compensation and/or adjustment assistance would be paid if it increased overall welfare.

Tackle market failures before addressing equity. Withers p. 247

Withers also made the distinction between compensation and adjustment assistance and suggested that governments should ‘not automatically reach for compensation per se’ but in the first instance look to adjustment assistance (that is, tackle market failure before addressing equity).

Cash is the most efficient form of compensation. Adjustment assistance can be in a form that alters behaviour. Forsyth p. 238

Forsyth claimed that, if the objective of compensation is simply to restore a person to the previous income level, the most efficient form is a cash payment. However, for adjustment assistance, a case can be made for its provision in a form that alters behaviour. For example, people may be given incentives to stay in a region rather than move to a city where there are external diseconomies resulting from further urban expansion.

Potential problems associated with compensation. Withers p. 247

Each of the discussants alluded to problems associated with providing compensation. Withers was not convinced about the need for specific compensation ‘for adverse incentive and rent-seeking reasons’. Stoeckel agreed with Kasper that it is impossible to calculate the ‘proper’ compensation, but observed that even if we could, we could never sell the policy to the public. He claimed that it is hard enough selling economic efficiency where the gains can be measured. Along a similar line, Saunders commented that providing compensation for structural reforms is ‘by no means a straightforward exercise, in part because of data limitations,

Stoeckel p. 265

Saunders p. 255

but also because of issues concerned with identifying who loses, and on what basis their loss is calculated’.

Saunders commented that he continued to be ‘amazed by the naivety with which many economists address the practical aspects of redistribution and compensation’. He suggested that often economists call for the adverse distributional effects of their policy recommendations to be offset by appropriate adjustments to the tax and transfer systems, with no apparent regard for how this might be achieved in practice. He was critical of Gray’s suggestion that new measures be introduced within the existing system to protect those who fall through the gaps. Saunders maintained that, in practice, extending compensation to those not currently protected involved radical departures from existing policy and practice.

Saunders p. 256

Saunders was not fully convinced by the argument that the broad-banding or phasing of reforms alleviates adjustment costs and reduces opposition to reform. Broad-banding may dilute resistance only by creating confusion. For adjustment through phasing to be successful, the reform has to be credible. That is, people need to have some trust in the political process. Saunders saw both the strategies of broad-banding and phasing as avoiding the central issue of making reforms equitable and efficient. In his view, if equity as well as efficiency can be clearly and convincingly demonstrated to the community, resistance to reform will be reduced.

Broad-banding and phasing avoid the issue of making reforms equitable and efficient.

Saunders pp. 258–9

Stoeckel also emphasised the importance of credibility by warning of the danger of reversal during the phasing period. He mentioned work by the World Bank showing that strong reforms (presumably with high adjustment costs) were more likely to succeed than weak or hesitant reform programs. Many weak reforms experienced a back-flip, with severe adjustment costs of their own as a result. He also noted that there were no practical rules for the sequencing of reform — simply reform whenever you can. Nor, according to Stoeckel, does it always pay to compromise. He used the tax debate as an example.

Danger of reform reversal when phasing ...

... and, it doesn’t always pay to compromise.

Stoeckel pp. 264–5

Policies should facilitate change. This lessens the need for compensation.
Stoeckel p. 266

Stoeckel observed that there are other ways to ease the burden of adjustment and facilitate change. This can be done through education, (re)training, and by improving the flexibility of the labour market and the economy more generally. If these types of policies are implemented, there will be less need for compensation.

General discussion

The discussion focussed on the following themes:

- compensation — circumstances when it might be appropriate, and potential problems associated with providing it;
- the role of the social security system and other support mechanisms; and
- phasing, preannouncing and sequencing reforms.

No single rule for when to compensate

No single rule, but there are circumstances when providing compensation would be the fair and sensible thing to do.

There was broad agreement among participants that there wasn't a single rule that could be applied to determine when to compensate. But many participants suggested that there would be circumstances when providing compensation would be the sensible and fair thing to do. Jeff Borland suggested that a set of guidelines (along the lines advanced by Argy) might be the best that we can do. Others were sympathetic to Walsh's 'exceptional circumstances rule', at least as a starting point for addressing equity, fairness and distributional issues.

What's fair when it comes to compensation?

Should land acquisition be different to other changes that affect asset values?

On the issue of fairness, mention was made of the guarantee under the Australian Constitution that the government provide compensation for the compulsory acquisition of property. The issue raised was should other areas (such as taxi and egg licences), where asset values depend upon government regulation, be treated any differently to the compulsory acquisition of land? Different views were expressed on this issue, reflecting differing assessments of the role of regulation in influencing asset values, varying

assessments of what constitutes fairness and different views on the role of legitimate expectations relating to the stability of regulatory regimes. Clearly, this issue is not easily resolved.

There was also some discussion on the need to separate out the ‘innocent victims’ of change from the ‘self-interest groups’. The general feeling was that compensation should be directed to those ‘people whose livelihood is likely to be very substantially disrupted or deprived’ by changes rather than to those who have had special privileges stripped away. However, it was observed by Sitesh Bhojani that deciding who are ‘innocent victims’ of change and who are ‘self-interest groups’ is sensitive to value judgements.

Innocent victims of change versus self interest groups.

Compensate to buy-off resistance to reform?

Some participants commented that providing compensation is likely to reduce resistance to reform. One participant made the observation that egg deregulation in New South Wales has happened (where compensation was provided) while taxi deregulation hasn’t happened. However, the direct and indirect costs (such as rent seeking and strategic behaviour), as well as the potential benefits associated with such a strategy, need to be considered.

Compensation may expedite the reform process.

Graeme Samuel was less convinced about the need to buy-off resistance to reform, suggesting that if more attention was paid to providing information, education, retraining and reskilling, the need for post-reform compensation would be considerably lessened. He noted that, to date, no financial compensation had been provided for any national competition policy reforms. Also, looking at prospective reforms in this area over the next 18 months or so (covering areas such as statutory marketing authorities, taxis, liquor licensing, professions, mandatory insurance schemes, pharmacies, newsagents, retailing trading hours, local government, competitive neutrality), he could not identify any areas where taxpayer-funded compensation should be required. In some instances, self- or consumer-funded adjustment assistance may be provided but, according to Samuel, even this was likely to be fairly restricted.

To date, no compensation provided for national competition policy reform ...

... and looking ahead can only see the need for self or consumer funded adjustment assistance.

Problems associated with compensating for change

Problems associated with compensation, including disincentive effects, moral hazard, identifying winners and losers.

A number of participants commented on potential problems associated with the provision of compensation, such as disincentive and moral hazard effects. Cliff Walsh suggested that making compensation and structural adjustment assistance packages regionally based, would reduce the risk of supply creating its own demand.

Another proposed strategy for minimising some of the potential problems was to make compensation conditional on some self-help by the individual.

The issue of identifying winners and losers was also raised. Nicholas Gruen warned about taking a static view of winners and losers, noting that ‘the risk with such preoccupations, especially when they are often focused on very small margins of winning and losing, is to end up in a quagmire’. He drew attention to the scope for the economic growth engendered by reform to ‘compensate’ losers and for economic reform in one area to generate ‘winners’ which were ‘losers’ in other areas. Thus dynamic and widespread reform over a broad front could generate its own kind of rough and ready compensation.

The role of the social security and wider support mechanisms

General view that Australia’s social security system should be the basic mechanism to protect low income earners.

A number of participants were of the view that Australia’s social security system should be the basic mechanism used to protect low income earners (families) from the adverse effects of reform or change. It was suggested that where reforms would clearly reduce living standards of low income groups (such as the GST), social welfare benefits could be adjusted. A number of participants also called for tighter targeting, so that those in most need could get a larger share of the social security budget. While there was general agreement that Australia has a good social security system, there was some debate about how generous it is.

Some participants agreed with Walsh's argument that Australia has witnessed the emergence of a 'social policy vacuum' since the mid-1980s, as a result of the progressive removal of tariffs and deregulation of the labour market and the absence of the development of alternative social support mechanisms. According to Walsh, this vacuum goes a long way towards explaining why we're facing so called reform fatigue (or resistance). A key challenge facing policy makers is to develop a new framework to address this vacuum. Ron Duncan expressed the view that getting rid of tariffs and centralised wage setting did not leave a gap in social policy, but simply removed monopoly rents held by vested interest groups.

Have microeconomic reforms created a 'social policy vacuum' which may account for growing resistance to reform?

Phasing, preannouncing and sequencing reforms

Stoeckel suggested that phasing could actually result in inequality. He used the wool industry to illustrate this point. Levying a tax on wool growers to cover the cost of the wool stockpile induced many to exit the industry, leaving the burden of the tax to fall on those who remained. Yet those who exited the industry may decide to re-enter when the tax is no longer levied, creating considerable inequities among wool growers. A more equitable policy would have been to sell the stockpile with all those in the industry bearing the cost.

Phasing doesn't always work; it may be inequitable over time.

Graeme Samuel commented favourably on the Industry Commission's proposal for handling the taxi plate problem. The Commission proposed that entry be liberalised over a number of years by selling new licences through public tender each year, with the possibility of the sale proceeds being used to compensate existing licence holders. In Samuel's view, this was an 'eminently clever way of filling in the taxi plate hole' and it was certainly a lot 'better and fairer' than suddenly deregulating taxi plate licences overnight.

Phasing could be the way to go when it comes to deregulating taxi plate licences.

Another comment made on the implementation of reform was that the wrong sequencing of reforms (for example delayed reforms to government business enterprises and labour market arrangements) has led to higher adjustment costs.

Incorrect sequencing of reforms leads to higher adjustment costs.

3 Distributional effects of structural change: some policy implications

Fred Argy

3.1 Introduction

Structural change (ie on-going shifts in the distribution of activity and resources within and among firms, industries and regions) is an essential concomitant of economic growth and rising living standards. However it involves a painful adjustment path for many people and the long-term benefits can be very unevenly distributed. Should governments be concerned about this? If so, how should they respond? This paper aims to address such broad questions and at the same time tries to deal with a number of specific questions posed by the Productivity Commission in its brief (appendix A).

Over the last two decades, governments of all persuasion in Australia and across the world have taken the path of economic liberalisation: they have freed up trade and investment flows, deregulated markets and reduced their role in the economy. The development of more competitive and better functioning markets has promoted a more efficient use of resources and a better climate for technological and product innovation. Australia has been among the earliest countries to opt for liberalisation and is now among the first to reap the fruits: the 1990s are proving a golden decade for growth in productivity and living standards.¹

Not all the so-called ‘reforms’ have produced genuine gains. Some of them have been of dubious merit (such as extension of privatisation into areas of near-monopoly). Others have produced statistical gains in productivity but at the cost of greater demands on workers or lower quality of service or increased environmental pollution. All in all, however, economic reform has paid off handsomely in improved efficiency, competitiveness and living standards in Australia. Although some of the increase in productive potential went to waste in higher unemployment, this is not the fault of the reforms per se.

So there is a strong positive side to economic liberalisation. The negative side is that the benefits of economic reform tend to be slow and unevenly distributed across the

whole community and some people are often asked to bear a disproportionate share of the costs of adjustment.

If economic reform only involved the occasional structural employment shock (say a reduction in tariff or regulatory protection for a particular industry which is regionally concentrated), it would cause some adjustment pressures but for the most part the costs would be *short-term or transitional*. However what we are witnessing is a fundamental and sustained change in the thrust of economic policy — a systematic shift from statist and protectionist policies to free market, pro-competition policies. This has the potential to create *cumulative long-term income and wealth distribution effects* — both across households and across regions.

Rising inequality is not an inevitable outcome of microeconomic reform and structural change. Many individual reforms such as tariff reductions and competition stimulating policies have progressive effects on distribution (Argy 1998a, p. 51; Creedy and Dixon 1998). And while many reforms (eg labour market deregulation) have regressive effects, it is conceivable that a series of structural and technological changes can have mutually offsetting effects on distribution, leaving the level of inequality broadly unchanged in the long term even without any government intervention.

In practice, the evidence suggests otherwise. In the United States between 1979 and 1996 there was an enormous increase in prosperity and a fall in unemployment. Yet some 50 per cent of the labour force experienced a decrease in real income, with the bottom fifth earners suffering a fall of 44 per cent in that period (*Economist*, 16 January 1999). Something rather similar has happened in the United Kingdom and New Zealand (Argy 1998a, chs 13–14). It is only in the last few years that the benefits have begun to trickle down.

In Australia, firm government action has helped to shelter the very poor from the harsh effects of markets, but otherwise the benefits of growth have been highly concentrated and there have been many casualties from structural change (see section 3.2.1). If we continue relentlessly down the path of ever-increasing economic freedom without doing more to smooth some of its social effects, we run the danger of deepening social class divisions and tensions, as well as causing a sharp backlash against structural change and economic reform.

The truth is that an ambitious microeconomic reform agenda can create serious conflict between efficiency and equity. This poses a dilemma. On the one hand, in a competitive, integrated world economy, there are strong pressures on us to continually improve efficiency. On the other hand, there are signs of growing social tension as the gains and losses are unequally shared. How should governments respond to this dilemma? There are three distinct views.

One view is that governments should freeze or slow down the pace of structural change — eg by re-imposing protection or regulatory barriers and giving public ownership a bigger role. This can be called the *statist* option. The overriding intent is to enhance social and employment stability in the short to medium term, even if it means using blunt economic instruments which retard long term economic growth. Statists deal with the globalisation/distribution dilemma posed above by largely opting out of the global economy.

At the other end of the spectrum, there is a view that governments have no choice but to go much further down the free market path (with deregulation, privatisation and smaller government) and should not worry unduly about losers and winners. This can be called the *hard liberal* option. The overriding intent is to promote economic freedom, which is seen as positive for economic growth but also as a ‘public good’ in its own right (Kasper 1998). Hard liberals deal with the globalisation/distribution dilemma by pointing to favourable trickle down effects from faster growth and the availability of a basic social safety net and otherwise opting out of distribution.

A third view is that governments should continue to facilitate structural change, including through more efficient, flexible and competitive markets, but, at the same time, actively seek to temper its harsh social effects (‘social smoothing’). This is the view I hold.

The paper is structured as follows:

- Section 3.2 looks closely at the goal of social smoothing. What is it trying to achieve? In what sense is such a goal ‘equitable’? Is it attainable? ie are redistribution policies feasible and are they compatible with good economic performance?
- One potential win/win form of social smoothing is targeted, ex ante social smoothing. Section 3.3 spells out in broad terms what this would entail. In the process, it looks at a range of practical problems of implementation and points to efficient and effective methods of smoothing.
- Section 3.4 discusses other less targeted forms of ex ante social smoothing viz. ‘log rolling’ (broad-based integrated reform) and reform dilution.
- Ex ante smoothing may not be always practicable. So section 3.5 outlines criteria and processes for ex post social smoothing.
- Section 3.6 sums up the main conclusions.

Since the paper is concerned with microeconomic reform, efficiency and equity, these terms need to be defined.

By *efficiency* we mean a situation where producers have the maximum incentive and capacity to:

- reallocate resources from activities of low net value to activities of higher net value (allocative efficiency);
- get more output out of the same productive resources (technical efficiency); and
- respond speedily and flexibly to changing international and domestic conditions (dynamic efficiency).

By *microeconomic reform* we mean any government action which achieves higher efficiency by making markets freer and more competitive and removing unnecessary government regulations and controls on markets and managers. This distinguishes it from other ways governments can improve efficiency, such as through industry policy or labour market policy (which seek to correct intrinsic market failure and require greater government intervention).

The term *equity* is vague and is the subject of a full discussion in section 3.2.1, but suffice to say here it is about making consumption more equal across the population.

The questions to be discussed are in good part about economic analysis. What is the best means of achieving given social ends? Are markets more prone to failure than governments? Do egalitarian policies hinder economic performance? And so on. However, we are also discussing ends and values — what kind of society do we want? Such values are personal and no one should make claims to the high moral ground. I certainly do not myself either here or in my book (Argy 1998a).

3.2 The goal of social smoothing

This section outlines the reasons why governments should not leave the distribution effects of structural change to the market. It tries to integrate equity, as well as efficiency, goals into the evaluation and formulation of microeconomic policy.

A gain in economic efficiency can make a major contribution to social welfare (overall human well-being) but it is not sufficient by itself to ensure that welfare is enhanced. This is so for four reasons:

First, an improvement in GDP per person hour only means we are using the nation's productive resources more effectively. It does not mean we are utilising these resources fully. Increased productivity could be reflected in more output per worker, but less employment.

Second, even assuming full employment, an increase in productivity may be at the expense of the quality of life of many people. For example, an increase in productivity which causes an increase in traffic congestion or noise, water and air pollution, or increasing stress in the workplace and family, is not necessarily an improvement in social welfare.

Third, an increase in productivity may be at the expense of a major erosion in our natural capital — our forests, waters, air, etc. and other non-renewable natural resources.

Finally, and of most relevance to this workshop, an increase in real GDP per person hour tells you nothing about how the income gains are being distributed. An increase in national income which is associated with big losses among lower income families and big gains among higher income families, is not necessarily evidence of an improvement in social welfare. The evaluation and formulation of microeconomic policy should therefore have regard for equity as well as efficiency.

Professor Martin Krygier, the 1997 Boyer lecturer, summed up these four reservations about an efficiency-only approach in one sentence. He said ‘the gross amount of goods in a society must never be judged in isolation from other values, but in terms of its contribution to and its comparability with other social goods, among them civility, decency and justice’ (Krygier 1999).

In keeping with the focus of this workshop, this section will focus heavily on the distribution issue. It seeks to address three questions:

- What is the equity goal we should be trying to achieve? (section 3.2.1)
- Are redistribution policies effective in achieving their equity goal? (section 3.2.2)
- Is the pursuit of equity compatible with strong economic performance? (section 3.2.3)

In answering these questions the paper will try to show in what ways the progressive liberal approach differs from the hard liberal approach.

3.2.1 Defining the equity goal for policy purposes

We said earlier that a rise in GDP with a ‘bad’ distribution of the benefits may not indicate an improvement in economic welfare. But what is a good or bad distribution? What should be the equity goal or benchmark to keep in mind when evaluating the social effects of microeconomic reform proposals against its efficiency benefits?

I will assume that we are only concerned with the *incremental* costs and benefits of economic reforms and associated structural change across the community. This does not in any way imply a lack of concern about the fairness of the existing distribution of income and the incidence of poverty. My own personal views on this are explained in my book (1998a, ch. 8) where I make two points. First, it would be too extreme to label the Australia of the mid-1990s as an ‘unjust’ society. We can boast that we managed to achieve good productivity outcomes over the last couple of decades at a much lower social cost than in other reformist countries. We successfully insulated the poor and disadvantaged from the harsh effects of structural change.

That said, my second point is that we should not be complacent about our present social structure. Some of the good social outcomes achieved in the 1980s are at risk of getting undone. We are seeing:

- an erosion in the relative value of many welfare benefits and a harder community attitude towards dole recipients;
- growing earnings inequalities in the market place;
- a decline in the quality of life of many workers (increased casualisation and insecurity, reduced workplace protection, more unpaid overtime, less predictable working hours and greater stress);
- growing regional disparities in jobs, incomes and services; and
- increasing strains on our social infrastructure (hospitals, schools, community services and public transport).

As well we have become mired in high unemployment and under-employment. On some measures even poverty levels seem to be high and increasing (see appendix A3.1).

Some pain is always associated with structural change and reform. But the pain and gain seem to have been very unevenly distributed. In my Sambell Oration (1998c), I attributed this to two policy failures.

First, a failure to give unemployment the priority it deserves — reflected in an over-cautious view of the so-called speed limits of economic growth and excessive timidity in investing adequately in labour market programs, productive infrastructure and human capital.

Second, there was insufficient thought given by ministers and their advisers to the second and third round effects of their reforms on distribution and quality of life. Nor was enough done in the 1990s to address these effects after the event.

Whatever the reasons, this decade is proving a good one for economic efficiency and growth, but one marred by increasing signs of an ailing society. Policy reformers should be focusing at least as much (if not more) on the looming social malaise, as on achieving further improvements in economic efficiency.

In the light of the above, an argument can be made for *undoing some of the past distribution effects of structural change*. However, this is controversial and it is not a pertinent issue for the Productivity Commission workshop.

The rest of the paper will therefore focus only on how governments should deal with the *incremental* distribution effects of *future* structural change. Or to put it differently, what is a good and bad way to share the incremental gains of economic reform?

There are at least three schools of thought on this question.

One view is that it is a stupid question. Hard liberals who hold this view argue that an economic reform should be allowed to proceed so long as:

- the aggregate discounted gains from the reform exceed in value the aggregate losses; and
- it appears *conceptually possible* for the gainers to *potentially* compensate all the losers in full and remain themselves better off than before.

Under this policy approach, the distribution effects do not need to be formally considered, as the main game is to increase the size of the national economic pie. It is taken for granted that, in the end, everyone will be better off.

A second, softer viewpoint is that the state should ensure that people dependent on welfare (effectively the bottom 10 or 15 per cent) do not get left behind the rest of the nation. This is essentially what the Hawke/Keating governments did very successfully.

A third school is softer still. It wants to make sure that every major income group shares in the gains to some extent.

How one responds to these three views is very much a subjective matter. Personally, I find myself somewhere between the second and third view. I find the Hawke/Keating approach a little inadequate because while it protected the really poor, it left many near-poor (those in the third and fourth deciles) worse off as a consequence of structural change. As to the third school, it is too ambitious. Their goal of virtually unchanged distribution is largely unachievable.

But I don't want to argue the fine points between the second and third school. My main fight is with the hard liberal approach. Let me explain why I firmly reject it.

First, I believe it fails the basic social welfare test. It would only ensure a *potential* not an *actual* welfare improvement. It would enhance 'efficiency' (as defined in the introduction) but, as already noted, social welfare is also a function of distribution (Kakwani 1995). The assumption, implicit in the hard liberal view, that losers have broadly the same welfare function as the winners, irrespective of their starting welfare position, is intuitively untenable and has no firm support in the welfare economics literature.

Apart from failing to ensure an overall social gain, the hard liberal approach could produce a progressively more unequal society. This is exactly what happened with economic reform in countries like the United States, the United Kingdom and New Zealand, which did not attempt through redistribution to ensure that the benefits were widely shared (a point already made in the introduction). As I will argue later, if inequality increases too far ahead of community norms, it is bad for society and not necessarily good for the economy.

So we have basically a choice between two distinct strategic views on how distribution should be integrated into the evaluation and formulation of microeconomic reform:

- One says that *over a reasonable period of time*, the poor and near-poor should share to a significant extent in the benefits of economic growth and there should be no large increase in inequality. This would impose an obligation on governments to try to offset or soften the undesirable distribution effects of structural change — not every single year or on every individual reform, but over a number of years and for a reform program as a whole (whether government-induced or market-induced).
- The other says that this is all bunkum, that we should focus on getting a strong economy going and, apart from having a basic social safety net, leave distribution to the markets.

Why do these two views differ so markedly? Some insist that it is all about economics. I firmly believe that the underlying reason for the difference between hard liberals and social progressives is that they have a different view of what is fair and just — proving that equity, like beauty, is all in the eye of the beholder.

To illustrate this point let me pose a simple question.

Suppose there are two ways a government can achieve a desired economic outcome (say a target unemployment rate of 5 per cent by a certain date). Call them options

A and B. Option A involves more government intervention, but option B achieves the same result through freer markets. Suppose also option B produces much more inequality than option A.

Which option should the Government choose?

Progressive liberals would opt decisively for the first option.

But hard liberals would hesitate and probably opt for option B.

Why this difference? It is not because hard liberals question the importance of social harmony. On the contrary, they accept it is an important public good and a critical ingredient of human happiness or well-being.

What is in dispute is the *path to* social harmony. Hard liberals see competition, individualism and property rights as the best way to avoid social conflict (Kasper 1998). Progressive liberals see consensual, communal policies as better promoting harmony. It is a matter of socio-political values.

In the context of microeconomic reform, the key disagreement between hard and progressive liberals is that progressives see equity in terms of avoiding wider vertical inequalities, but hard liberals see it in terms of maximising economic freedom and minimising government interference with individual autonomy. To hard liberals, it is overwhelmingly important that people be allowed to do their own economic thing and reap the full rewards of their efforts.

Moreover, hard liberals see freedom very much in terms of protection of private property rights and treat redistribution as ‘confiscation of the very private property rights that governments once were charged to protect’ and the welfare state as impeding self-responsibility (Kasper 1998, pp. 19, 106–7). Hard liberals also see voluntary idleness as a serious threat, and want to pare back the welfare state ‘with governments only coming in once private effort, family, and voluntary community resources have been exhausted’ (Kasper 1998, p. 10).

Indeed, the concern of hard liberals about individual economic freedom is so strong, that many give it higher priority even over political freedom, parliamentary democracy and judicial independence (eg see Kasper 1998, pp. 109–26). And, they are often prepared to sacrifice GDP per head to achieve higher economic freedom (Argy 1998a, ch. 5).

How do economists resolve such values differences? They can’t. But let me tell you why I personally do not want to give increased economic freedom priority over vertical equity.

Economic freedom is, of course, important. If it is too constrained, it can seriously damage the economy and threaten basic liberties (as we acknowledge in section 3.2.3 below). Equally, however, too much protection of economic freedom (property and business) can involve large claims on the public purse (requiring elaborate machinery to enforce this protection) and a denial of other legitimate rights. ‘Rights like any other claim have opportunity costs’ (Holmes and Sunstein 1998).

The only issue, therefore, is not *whether* we should have economic freedom, but *how much economic freedom do we want*. Progressive liberals point to the big expansion of economic freedom in the last two decades and see no evidence that it is unduly restricted. Indeed, they would be prepared to trade off some existing economic freedom (in the form of higher taxation) for other public goods (such as equal opportunity programs — see section 3.5). To them, freedom in the economic arena is not just about negative rights, ie immunity from government encroachments on freedom of contract or protection against ‘expropriation’ of property. They view the obligation of the state more broadly as one of providing the benefits of a civilized society to everyone, expanding the opportunities available to individuals and removing the obstacles to a good life, self-fulfilment and full expression of citizenship rights (Argy 1998a, pp. 61, 118).

If economic freedom were always associated with genuine equality of opportunity, one could accept that it would produce a ‘fair society’ of sorts — at least in the sense of people having an equal chance to achieve. However, wide income and wealth inequalities and high concentrations of economic power are not consistent with equality of opportunity and access and, hence, with true liberty of the individual (Rawls 1971, p. 278). It is, in my view, impossible to have genuine equal opportunity in a society with unequal access to education, health, decent housing, the justice system, transport and other services essential to future success in the labour market.

Even if one could ensure effective equality of opportunity (a very laudable aim in its own right, as argued later), it would not by itself achieve social harmony. Social harmony means trust in the system and broad acceptance of the legitimacy of the policy making process, so that even those who disapprove of the outcomes accept that the policy processes are fair, honest and transparent. There would not be widespread trust in a system which consistently produced widely unequal outcomes. In a country like Australia which, unlike the United States, does not have a long tradition of harsh individualism, a shift to a US-style free-for-all would mean a serious break with community expectations, which in turn would seriously erode the cohesiveness of our society.

But this is only one person's opinion. What do the majority of Australians think? Public opinion surveys show that Australians have a strong sense of community and a desire to improve their community (Eckersley 1999). Australians — especially young people — reject a lot of the values associated with wealth generation and competitiveness and overwhelmingly prefer a greener, more stable society, 'where the emphasis is on cooperation, community and family, more equal distribution of wealth...' and on 'shared values and a more cohesive sense of community' (Eckersley 1999, pp. 9–10).

Similarly, Cox (1999, p. 158) reports that in surveys asking people about the types of society they wanted 'many and increasing proportions of people felt Australia was becoming more unequal and less like their ideal'. She argues that social capital — the links which bind non-family members of society together — is eroded if there is increasing inequality and that this may explain why despite increasing material affluence, the polls are showing increasing anxiety and unease in the community (Cox 1999, p. 162; Eckersley 1999).

In short, a great many Australians seem to share my belief that a sense of fairness about distribution is an essential element in a cohesive and stable society.

'Any society needs to be seen as fair and just by its citizens, otherwise people will become disillusioned, alienated and disaffected' (Saunders 1999b).

Let me sum up this 'philosophical' discussion and relate it to the theme of this workshop:

- In evaluating a proposed microeconomic reform to determine whether it is likely to be welfare enhancing, a hard liberal would assess the reform equally in terms of what it does to GDP per head and in terms of what it does to economic freedom. A progressive liberal would assess the reform equally in terms of what it does to GDP and how well the benefits are shared. (Progressives would also be more willing to acknowledge and respond to externalities.)
- The assumptions underlying the progressive liberal stance are:
 - (i) that any cost-benefit analysis of a policy proposal must have an 'implicit' utility weighting in favour of lower income groups; and
 - (ii) that rising inequality is a destabilising force in a society like Australia's and ultimately incompatible with social harmony, so every effort should be made to ensure lower income groups actually share in the benefits of economic reform.

I am not saying that the disagreement between hard and progressive liberals is all about values. There are also disagreements centring on whether the two alternative

policy paths can indeed achieve equally desirable economic outcomes. For example, they disagree on such economic questions as:

- How effective are social smoothing policies?
- Do such policies have a damaging effect on economic performance?
- Is more economic freedom necessary for sustained economic growth in Australia?
- How broad are the opportunities for welfare enhancing economic policies directed at addressing market and institutional failures?

But a clash of values has a lot to do with it too.

3.2.2 Are redistribution policies effective in achieving their equity goal?

Setting the social distribution goal is one thing. But is it attainable? This question has two subquestions: First, do redistribution policies work — are they effective in achieving their own intended goal of sharing the benefits of growth and alleviating poverty? Second, whatever they might do to levels of inequality, are they counter-productive for the poor in the long term because of their effects on the economy?

The first sub-question is addressed here and the second in section 3.2.3.

Many hard liberals deny there is any ideology involved in their thinking. ‘... it is not a matter of normative preferences — but a matter of what works’ (Kasper 1998-99, p. 41). In their view, redistribution policies simply don’t work in an economy exposed to global disciplines. Apart from having bad economic side-effects (a separate issue discussed later), such policies (they say) are ineffective in helping the very people they are trying to help.

In its crudest form, the argument that redistribution policies are ineffective or perverse relies simply on evidence that the numbers of poor and the level of inequality keeps increasing despite record amounts being spent on welfare. But this confuses cause and effect (welfare spending rises because of higher unemployment and growing inequality not the other way round) and it tells us nothing about what might have been the situation if we had not had redistribution policies in place. At the very least, it can be said we have spared ourselves the harshness of American society. Indeed, there is convincing evidence that Australia’s welfare initiatives in the 1980s achieved their intended purpose of protecting the poor from the harsh impact of economic reform and succeeded in reducing poverty (Harding and Beer 1999; Harding and Szukalska 1999).

The argument that redistribution policies are ineffective is also used in relation to active labour market programs (an important instrument of redistribution). The contention is that such programs do not deliver what they promise and do so at high cost. If it were true, this claim would be very damaging for progressive liberalism as the latter relies heavily on the belief that active labour market programs are an effective substitute for full deregulation of the labour market. This issue is also taken up in section 3.5, where it is argued that some programs work and some don't (it depends on design and implementation), and that the doubts usually expressed about the effectiveness of labour market programs apply logically to labour market deregulation as well.

This is not to say that all attempts at redistribution are successful in achieving their social goals. Indeed, later sections of this paper point out the many practical and economic constraints. However, a theme of the paper is that if the right instruments are used, social smoothing can be effectively implemented.

Another, more serious, objection is that a welfare society encourages welfare dependency — that is, it destroys the work ethic and traps people in poverty (Kasper 1998, p. 107). This is an issue that deserves and is receiving increasing policy attention. The extent of the problem depends on the types of ongoing instruments of redistribution used. These are discussed in section 3.5.

3.2.3 Are redistribution policies compatible with strong economic performance?

Here we look at the argument that the economic costs of redistribution policies are such that they make the total economic pie smaller and hence are counter-productive for the poor. The economic implications need to be spelt out in some detail because they are fundamental to the overall social welfare rationale.

The redistributive capacity of any country depends on the productive capacity of its economy. If the social wage (the amount of cash and goods transferred from well-off to disadvantaged families) is set too high, it can greatly weaken the incentive to work, save, innovate and invest and undermine economic performance. When that happens, social smoothing may well have net negative effects on economic welfare and prove counter-productive for the poor — no matter what it does to the level of inequality.

However, in international terms, Australia has a rather modest welfare state relative to its productive capacity. Moreover, the productive capacity of the Australian economy has been increasing markedly over the last decade, so in theory its

redistributive capacity should also have increased. *Prima facie*, there is no basis for claiming that we can ‘no longer afford’ the present level of the social wage.

That said, the relative productivity of unskilled workers has declined, the economy has become more globalised and capital has become more mobile. So, we cannot afford to be too lax and generous with redistribution if we want to maintain work incentives and remain competitive and efficient. The only issue is whether, given our starting point, the kind of social smoothing proposed in this paper (which may well involve a slightly greater redistribution effort) could have detrimental effects on our productive capability.

The paper starts by looking at the broad economic effects of social smoothing — first in relation to adjustment assistance and then in relation to long term redistribution policies.

The economic effects of adjustment assistance

In my book (1998a), I deplore the tendency of many hard liberals to focus heavily on long-term equilibrium gains, to downplay the adjustment costs of structural change and to assume that the benefits of structural change ‘trickle down’ to everyone in the long term. The book argues that ‘this is an unacceptable approach to economic reform’ because economic adjustment costs can be prolonged and severe and should be an essential part of the welfare calculus and because the so-called ‘trickle down’ effect is so delayed that it is often a sham in practice.

The *economic* case for structural adjustment assistance basically rests on three arguments. First, it can reduce the extent of short term economic disruption during the transition phase. Second, it can minimize the risk of aggravating structural and long term unemployment. Such unemployment is economically wasteful and becomes increasingly difficult to eliminate the longer it endures. The relationship between unemployment and inflation is almost certainly asymmetrical. This means that if, at a time when the labour market is quite slack, there is a rise in unemployment from A to B, it tends to have no effect on inflationary pressures. But if the new unemployed (B–A) become entrenched as long-term unemployed, and the usual hysteresis effects set in, the attempt later to reduce unemployment back to its initial level (A) may generate unacceptable inflationary pressures.

If the structural unemployment effect is severe enough, it could have implications for the sustainable growth rate of the economy and nullify (for a few years at least) the efficiency benefits from the structural reform.

A third economic justification for adjustment assistance is that a ‘winners take all’ approach to economic reform stiffens resistance to future structural change and reform. Reforms are much more likely to be accepted and implemented smoothly if they are associated with adjustment assistance to those hurt by the shock.

The main economic argument *against* structural adjustment assistance (apart from practical problems of implementation discussed in section 3.3) is that it has a cost for revenue and, if carried too far and the wrong instruments are used, it can also impair efficiency. This issue is picked up later.

The economic implications of long term redistribution policies

As noted at the start of this paper, economic reform and structural change do not only have a transitional social impact. They can also have cumulative, longer term effects on distribution. That is why later in the paper (section 3.5) we will suggest that governments should engage in long-term social smoothing *ex post*. Is that likely to impair economic performance?

Long term redistribution policies designed to promote a more even sharing of the benefits of economic reform and structural change have a number of *positive economic spin-offs* (externalities) and an overriding economic rationale which often tend to be overlooked.

One economic positive is the same as for adjustment assistance — that is, it tends to make the community more receptive to further change and reform.

A second, and more fundamental, economic justification for long-term distribution policies (at least in principle), is that it is the surest way to ensure that structural change and economic reform enhance economic welfare — which is the ultimate goal of policy. This point was explained in section 3.2.1.

A third reason why it is economically sensible for governments to intervene when reforms produce wide income and wealth disparities, is that such disparities are inconsistent with a level playing field and, hence, with true competitive neutrality in the market place. They are, therefore, counter-productive for productivity growth in the long term. Large inequalities mean that the poor are disadvantaged in accessing transport, quality housing, health and education, thus limiting their opportunity and capacity to expand their horizons and contribute to society. They are also disadvantaged in accessing the banking and financial system because it tends to discriminate against people with good income prospects but poor collateral. As a result, large income inequalities lead to under-investment in human capital and

erode existing human capital (as the poor and unemployed are unable to enhance or update their skills).

A fourth economic argument for redistribution policies centers around labour market and regional policies, which are part of the redistribution machinery envisaged by progressive liberals. Well chosen labour market and regional policies have several economic spin-offs in their own right. They help correct market imperfections such as impediments to labour mobility and information deficiencies. They help lift the productivity of the long-term unemployed and to keep them in closer touch with the labour market. They tend to improve the competitiveness of some low skill labour relative to capital. The net effect is to reduce structural unemployment, raise the NAIRU (the minimum unemployment rate consistent with low and stable inflation), lower the speed limits on economic growth and increase the level of employment at any given level of output (Argy 1998a, ch. 10). Labour market adjustment schemes can also lessen the incentive for ‘rent-seeking’ and the risk of moral hazard.

A final economic justification for redistributive intervention is (as already noted) that wide and increasing inequalities can generate social disharmony, which in turn can create the seeds of social tension and instability. The full economic implications of this depend on the degree of instability caused and the political institutional arrangements in place.

Boutros Boutros-Ghali, when Secretary General of the United Nations, said recently that ‘a state in which inequality and privilege prevail is potentially in danger of suffering the greatest social upheavals’. If countries are in a developing stage and democratic institutions are not very robust, the discontent can spill over into civil unrest. In turn, social unrest can impact on political stability — which is highly correlated with economic growth (*Economist*, 27 January 1998).

In developed democratic countries, the ballot box offers a safety valve. However, the discontent can manifest itself in economic populism and distorted policy priorities or in ugly ways such as xenophobia, victimisation of minority groups, racial intolerance, etc. Such an environment can be economically destabilising and bad for long-term investment planning and innovation. Moreover, it runs the risk of frightening the politicians and slowing, or even reversing, the momentum of reform and structural change. On the other hand, cohesive, supportive and trusting communities tend to provide a climate conducive to productivity, innovation and continued reform.

These are the economic positives of redistribution policies. What about the economic negatives?

First, won't redistribution policies tend to create by-product distortions and resource allocation inefficiencies? The answer is yes if bad instruments of redistribution are used, but no if sensible ones are used. A discussion of what are 'sensible' policy instruments is deferred to section 3.5.

Second, doesn't a high level of social security benefits relative to post-tax income in work reduce the financial incentive to actively search for work and boost unemployment? The answer is that, in general, this effect is small relative to other influences on unemployment and especially so in Australia (see section 3.5.2).

Third, won't redistribution policies mean higher tax rates and won't this in turn blunt the incentives to work, save and take risks and won't this have welfare costs?

Socially progressive liberal policies may well mean higher taxes in the short term, but not necessarily in the long run. Piggott and Chapman (1995) have argued, for example, that many labour market programs pay for themselves in the long term.

There is little doubt that socially progressive policies will tend to be associated with higher tax rates in the short/medium term. However, Australia is at the bottom end of the international scale in terms of total tax revenues as a proportion of GDP and the 'wedge' between the cost of employing an average worker and their take home pay is lower in Australia than in most industrialized countries (OECD as reported in Henderson 1999).

That said, there is no doubt that some taxes have work disincentive effects and 'deadweight losses'. For example, if the tax increases affect the relative prices of various goods and services in ways which are unrelated to the social opportunity cost of producing those goods and services, it tends to distort people's choices and preferences. Interesting attempts have even been made to quantify the welfare costs of taxation. For example, Campbell and Bond (1997) calculate the effect on labour supply and hence the welfare cost of a 1 per cent increase in marginal tax rates. They find that a project needs a benefit cost ratio in the range of 1.19 to 1.24 (other studies have even higher figures).

Such calculations assume no involuntary unemployment. Moreover, the method of estimation of welfare costs is still an area of controversy in economics. It is not clear, for example, that high marginal tax rates at the top end of the income scale has much effect on work effort (an issue we return to later).

To sum up, economic logic alone will not tell us what the net economic effects of redistribution policies are likely to be. There are some potentially negative effects, but there are also many potentially positive effects. So what does the empirical evidence suggest?

The empirical evidence on relative performance of socially progressive economies

The empirical evidence is also inconclusive. Among similarly developed economies there does not appear to be a clear, consistent relationship between social progressiveness (in terms of levels of government social spending and benefits, worker protection laws, levels of inequality etc) and economic performance. I have set out the evidence in my book and more recently in an article in the *Australian Economic Review* (Argy 1998b), so only a brief summary of the international experience is required here.

1. On such criteria as output per head and employment growth, Australia, despite its socially progressive policies, performed modestly well in the 1980s and exceptionally well in the 1990s. It performed less well on unemployment but this can be attributed in good part to poor macroeconomic management of incomes (early-1980s) and demand (late-1980s). It can also be attributed to a slowness to address structural imbalances in the labour market, which allowed growing cyclical and technological unemployment to degenerate into intractable long-term unemployment. Labour market rigidities can, in turn, be as plausibly explained in terms of a failure to invest adequately in labour market programs and human capital as a failure to deregulate fully enough (Argy 1998a, chs 3, 13).
2. Some smaller socially progressive economies, such as the Netherlands, Austria, Denmark and Norway, have performed consistently well over the long term and into the 1990s, both on GDP per head and unemployment criteria. Larger progressive economies like Germany, France and Japan have performed very creditably over a long term perspective on most criteria, and as far as productivity growth is concerned they have performed well even in the 1990s. However these latter countries have slipped badly in the 1990s in terms of unemployment (Argy 1998a, ch. 13).
3. On any long term perspective (taking the 80s and 90s together), hard liberal economies (the United States, the United Kingdom and New Zealand) have not done well on either output per head or productivity growth, but in the 1990s, two of them (the United States and the United Kingdom) have performed well on the criteria of unemployment. New Zealand has improved its economic performance in the 1990s but over any reasonable time span has tended to lag well behind Australia on most indicators of performance (Argy 1998a, chs 11, 13–14).
4. Many of the differences in performance between the large European progressive economies and the United States and the United Kingdom, can be attributed to special factors in the latter and over-restrictive macroeconomic policies in the former. (See Argy 1998a, 1998b; Jackman 1998; Solow 1997 and more recently the *Economist*, 10 April 1999, pp. 67ff.).

In short, the relationship between social progressiveness and economic performance is inconclusive. It certainly does not refute the view that socially progressive regimes are compatible with strong growth and low unemployment.

What about the apparent relationship between levels of economic freedom (levels of tax and business regulation etc.) and economic growth? Certainly the evidence over the long term (1985–96) suggests that countries at the bottom end of economic freedom, such as Albania, Brazil, Egypt, Turkey and Algeria, have suffered economically relative to those at the top end of economic freedom such as New Zealand, Chile and the United States (Nahan 1997, quoted in Argy 1998a). But for a wide range of countries in comparable stages of development and in the middle levels of economic freedom, the relationship is not significant either way. Many countries at the lower end of this middle range (in terms of economic freedom) such as Austria and the Netherlands, have, if anything, performed better than those at the top end such as New Zealand and the United Kingdom (Argy 1998a, ch. 11).

It should be noted that Australia is somewhere towards the upper end of this middle range in terms of level of economic freedom and is a relatively ‘small government’ country (Argy 1998a, ch. 15). This point, coupled with the empirical evidence outlined above, seems to suggest that a marginal increase in redistribution (a marginal decline in economic freedom) in a country like Australia would be very unlikely to impair economic performance.

Conclusions on economic effects of redistribution policies

In conclusion, neither economic theory nor the empirical evidence lend firm support to the generalized concerns of neo-liberals about the adverse economic impact of redistribution policies. Nor, however, do they support the opposite view — that redistribution policies are positively favourable for the economy. What economic analysis does call for is an *agnostic stance* on the relationship between redistribution policies and economic performance.

This is hardly surprising. We know that the economic effects of redistribution policies depend on:

- (a) the stage of development;
- (b) how intensely the redistribution goals are pursued; and
- (c) the instruments employed.

If governments over-indulge in welfarism and choose the wrong instruments to carry out their goals (those which unduly impair economic freedom), the economy is likely to suffer. Otherwise, the impact is likely to be neutral to positive.

3.3 Targeted ex ante social smoothing

The Introduction outlined three alternative views about how governments should respond to concerns about the distribution effects of structural change. One of these approaches — that governments should try to prevent or slow down structural change, eg by imposing new protectionist or regulatory barriers and using them as instruments of redistribution — does not have wide acceptance and is not relevant to this workshop. (It is critically discussed in Argy (1998a, ch. 4) and some of the relevant concerns are raised in section 3.5 of this paper.)

This section discusses the progressive liberal approach to ex ante social smoothing. Clearly, this approach is anathema to hard liberals. They believe it involves pursuing a false equity goal, does not work anyway and is economically too costly. They want, if anything, less, not more, concern about distribution. We have rejected this viewpoint in the previous section. In the rest of the paper, we are concerned with *how*, rather than *why*, governments can pursue social smoothing.

Here we try to answer a core question raised in the Productivity Commission brief — viz. how should adjustment and distribution issues be dealt with in the process of evaluating specific policy changes? What types of adjustment costs need to be taken into account and how are these best assessed ex ante?

We start by assuming a shock or series of shocks (say some combination of economic liberalisation and technological change) which have an impact on distribution and which seem likely to produce appreciable net gains overall for the community — but with some people losing and many others not sharing at all in the benefits. Assume also the distributional effect has two dimensions — inter-regional and inter-household. The questions discussed are:

- (i) In what circumstances is it *feasible* to identify and compensate the main gainers and losers ex ante?
- (ii) Where it is feasible, what should be the *actual* government response?

3.3.1 Potential for assessing winners and losers ex ante

An ideal win/win solution requires that losers from a reform be compensated and the cost of the compensation be met by clawing back some of the gains enjoyed by

the winners. To intervene most effectively on distribution grounds, therefore, governments must be able to identify both potential winners and losers.

This may be feasible with some infrastructure projects. For example, improved road or rail services often help some local residents and businesses by raising their land values, but hurt others financially or in other ways (eg noise, pollution, decline in housing value, loss of business). The government (including local government) can use its powers to tax benefiting groups (eg through the rate system or some special appreciation tax) and compensate the losers. Even in such cases, there may be some losers as the increase in value and the boundary of the area covered would be difficult to define and it might not be possible to take account of offsetting costs to benefiting groups such as noise borne. But it would be as close to a win/win as one could hope to get.

The technique may also be applicable to some types of tax reform where winners and losers are broadly identifiable, as in the case of the proposed GST. It could also be applied to privatisation or commercialisation of public utilities. Suppose user pricing is introduced where previously businesses cross-subsidized households. It may be possible to compensate low income households with vouchers and assume that other households would benefit indirectly from lower business costs and prices and that this would offset the higher utility price. The revenue cost could be met through some specific tax on business (the winners). Similarly, the technique could be applied where a monopoly privilege, such as that enjoyed by newsagents and pharmacists, is removed. A tax specific to the winners (the consumers of these particular products) could be devised and the proceeds used to compensate the losers (the small business proprietors affected), subject perhaps to a means test.

Often, however, it may be possible to determine broadly who the losers are, but the winners are an amorphous group which can only be identified in very vague terms. Take, for example, a reduction in protection and the closing down of an unprofitable business on which a town or region depends. The losers are mainly the residents of the region — especially those in the labour force. However, the winners are dispersed consumers. In such cases, one might still be able to get close to a Pareto solution by compensating the losers and paying for the cost through indirect taxes, which impacted universally and broadly left the cost of living unchanged. The same can be said of, say, an adjustment in the minimum wage. Losers are broadly identifiable and can be compensated through earned tax credits as proposed by the Five Economists (Dawkins, Freebairn et al. 1998) and Argy (1998a, pp. 147–8) but the winners (apart from those previously unemployed) must be assumed to be taxpayers at large. This might produce an approximate Pareto optimal outcome, but there is no certainty about it.

Rough justice or not, it would be better than doing nothing to compensate losers. It would also be better than relying on the safety net in the short run and trying to pick up the long term social problem through redistribution policies ex post (a strategy discussed in section 3.5). Many structural reforms may have ill-defined distribution effects, but the broad direction of the changes is clear. If losers can't be identified, yet it is known that there will be serious adjustment costs for some and the distribution effects will definitely be regressive in the long term, is it fair to wait for eventual confirmation in three or five years time? And is it sensible, given the need to mobilize community support? Some form of ex ante action may be necessary to provide short-term relief and to satisfy community concerns — even if it confers only rough justice.

A great many cases will not lend themselves to any reasonable ex ante identification of either winners or losers. This is true, for example, of financial deregulation or changes in industrial relations policy (eg measures which severely reduce the role of the trade unions and the protective role of the Australian Industrial Relations Commission) or general changes in trade and competition policy. Indeed, many structural reforms only impact gradually over a considerable period of time and in a very diffused way. The effects on regional or household distribution are not easily assessable and predictable in advance. Winners could be shareholders, consumers, particular groups of workers, etc, but it would be impossible to know in advance. The losers too are hard to pick specifically ex ante, even though they may well be the more vulnerable workers in the community. This problem is compounded by lack of adequate data on how different reforms impact on particular households and how genuinely 'poor' some low income households are.

In such cases, even rough and ready compensation is not feasible. The Government could then consider reform dilution or complementary economic and social reforms (log rolling) as forms of ex ante social smoothing. These options are discussed in sections 3.3.3 and 3.3.4. Otherwise it must resort to ex post smoothing (section 3.5).

In the rest of this section, it is assumed that losers can be roughly identified and rough compensation or adjustment assistance is *technically* feasible.

3.3.2 Potential for political implementation

Even where compensation of losers is technically feasible and a reform seems likely to produce near-Pareto optimal outcomes, implementation may be difficult because of political institutional obstacles, such as a federal structure, a bicameral system, semi-proportional voting arrangements, etc.

A more general problem common to all democracies has been well enunciated by Stiglitz (1998) in a recent article. He accepts that it is hard for large diffused winners to defend themselves against a concentrated interest but this, he says, does not explain why win/win policies, such as the removal of a subsidy to farmers with full compensation to the farmers, fail to be adopted.

Stiglitz puts forward a number of hypotheses to explain this dilemma. The main one is that governments are unable to make longer term commitments which can adequately reassure people who:

- think they might be foregoing *potential gain* in the future if the reform proceeded;
- see the reform as setting a *precedent* for similar reforms which could potentially harm them (thin edge of the wedge); or
- fear the compensation might be eroded or withdrawn gradually over time (eg because a previously hidden subsidy would become ‘transparent’ or because of fiscal constraints).

The problem stems from the inherent nature of government itself — that governments can change their minds and earlier ‘agreements’ may not be enforced.

Stiglitz also argues that failure to implement potentially win/win reforms is sometimes due to what he describes as ‘destructive competition’ in an imperfect political market, with imperfect information and mutual mistrust.

All of these hypotheses seem relevant to Australia and especially to issues such as shifts in trade or industry policy and wage/tax trade-offs. Stiglitz suggests that one solution lies in establishing independent agencies in many areas, so as ‘to move critical parts of decision-making at least slightly further from the political scene’. But this raises problems and complexities of its own, as recent concerns about the excessive independence of central banks in New Zealand and the European Union illustrate.

An alternative approach would be to establish an effective consensus-building forum such as a fortified EPAC (see Argy 1998a, pp. 243–5). Stiglitz (1998, p. 16) himself alludes to such a possibility.

3.3.3 In what circumstances should ex ante targeted compensation occur?

Even if losers can be identified and there are no technical or political constraints, it does not follow that governments should automatically compensate. Obviously,

governments cannot put out every single distributional bushfire which flares up during the process of technological and structural change and reform. They must be both selective and restrained. The Productivity Commission briefing paper asks a number of pertinent questions in this regard. Some of these are now discussed (albeit using slightly different phraseology).

When is a distribution effect bad enough to warrant policy concern?

Given that it would be neither sensible nor feasible for governments to try to ensure, *ex ante*, that each individual reform was distributionally benign, how do governments decide which reforms need to be considered for potential compensation?

In my view, structural reform shocks should qualify in principle for adjustment assistance or targeted compensation if they seem likely to produce very uneven net benefits and:

- they have *disproportional* and *substantive* economic and employment effects on a *particular region* which is already economically disadvantaged or vulnerable;
- they *hurt people who are already relatively poor or otherwise disadvantaged*, alienating them further from the rest of society;
- they *benefit wholly or predominantly the rich*, thus intensifying the level of inequality and depth of social division; or
- the reforms are policy-induced and represent a breach with long standing traditions or legitimate expectations.

Apart from the last point, which relies more on a semi-legalistic view of justice as an ‘implicit contract’, the criteria warranting intervention rely on a judgment of what is a good and bad distribution effect, having in mind not only ethical issues, but also the kinds of economic and social implications outlined in section 3.2.

‘Bad’ relative to what?

In judging whether a distribution effect is bad, the assessment must be done with full regard for the counter-factual alternatives — what might happen to income distribution, and especially the situation of the poor, if the reform program were not to proceed?

The two main counter-factual alternative scenarios would be:

- (a) where some other equally effective policy device is used instead to achieve the desired policy goal; or

(b) where the policy goal itself is abandoned or diluted.

The distributional effects of these counter-factual alternatives may not be easy to assess, but without such an assessment the distribution analysis is incomplete.

Suppose the policy goal is to improve the competitiveness and employment absorbing capacity of under-performing regions and the idea of a ‘discounted minimum wage rate’ is being considered for such regions. Suppose also the following alternative package is being considered as a means of achieving the same goal:

- a regionally oriented public infrastructure program
- new regional investment incentives for business
- a relocation of government departments
- region-specific training and wage subsidies
- support for local regional initiatives.

It is, of course, a matter for debate whether such an alternative package would achieve exactly the same results as a discounted minimum wage rate. But let us suppose it would do so approximately. The following question then has to be asked: what would the distribution of incomes/wealth look like under such an alternative scenario?

Prima facie, one would say that given a progressive tax system, the alternative package would have more benign distribution effects (eg a ‘discounted minimum wage rate’ for targeted regions would have more regressive effects than wage subsidies for the same regions).

But suppose such an alternative package of measures is ruled out (for fiscal or other reasons). The real alternative to the idea of discounted wages for under-performing regions would then be to *do nothing* to attack regional unemployment. Under such a ‘do nothing’ scenario, the distribution outcome (or at least the situation of the poor) could conceivably be worse than under labour market deregulation.

In short, it is important when assessing the distribution effects of a reform program to set these effects in wider perspective and against the alternative options. This, of course, greatly complicates the analysis, but it is usual for a Productivity Commission inquiry to explore various alternative ways of achieving the goals set down in the terms of reference before recommending a particular policy course. So it would not be a major additional burden to explore the distribution dimension as well as the economic effectiveness of these various alternatives.

Should governments respond to each individual reform separately? Or should the reforms be grouped together for purposes of the distribution assessment?

In general, distribution effects should not be assessed ex ante for each individual shock or reform in isolation, as losers from one may be winners from another. Indeed, we argue later that a deliberate attempt should be made, where approximate, to introduce ‘offsetting’ reforms in tandem. So the focus of distribution analysis should be on a proposed integrated program of reform over a period, assuming that the full program is transparent and on the table.

Political and practical factors may not allow such a rational approach. Governments often deliberately indulge in obfuscation about their true reform intentions, so that the full scope of the reform program may only become evident bit by bit (the Howard Government has proved a master of this technique, especially in respect of industrial relations reform).

So it may not always be possible to look at a group of reforms in conjunction with each other, or to compare the package with an alternative strategy or to assess the distribution effects ex ante (other than in hypothetical terms). In these circumstances, it would be reasonable to consider compensatory action ex ante on individual reforms, but only if the shock is severe and substantial numbers of poor households are adversely affected. Otherwise, the alternative options discussed in sections 3.4 and 3.5 of the paper might have to be considered.

Should policy-induced changes be treated differently from market-induced changes?

A further critical question posed by the Productivity Commission is whether the adjustment costs and/or longer term distribution effects caused by *policy-induced microeconomic reform*, should be treated differently from those caused by *market-based structural change*.

In principle, the answer should be no because the rationale for intervention (as outlined in section 3.3 above) is broadly the same (with some slight qualification) whether the trigger is the market or government. Take, for example, the argument that intervention reduces resistance to reform. This has most application to policy reform, but the attitude of unions, workers and the community at large to employer proposals for structural change can be a significant barrier to change, and deserves almost as much policy attention as resistance to government-induced reforms.

True, the *moral* case for intervention has slightly less force in the case of market-based structural change than for policy-induced microeconomic reform. This is

why, in section 3.3.2, we suggested that one of the conditions which might justify government intervention was where there was ‘a breach with long-standing traditions or legitimate expectations’.

In practice, moral responsibility is often a matter of political pragmatism. Governments have intervened after market-induced shocks. For example, the present Government has tried to address the distribution effects of the gas breakdown in Victoria, the steel shut-down in Newcastle and the impact of market developments on the pig meat industry. Governments have even at times tried to obstruct structural change itself (eg the ban on big four bank mergers and protection of the quasi-monopoly position of newsagents and pharmacists).

In any case, the two kinds of shocks often interact and have very similar effects in practice. A major series of reforms which free up markets can have an initial direct policy-related effect (eg a change in the price structure of banks) followed later by secondary indirect effects (eg banks closing down regional branches). How are the two distinguished? Similarly, a market-based rationalisation of the textile industry (prompted say by a merger or new technological and market developments) can generate long term regional unemployment and increased social inequality — in exactly the same way as a shift in trade policy which leads to a reduction in TCF industry protection. If governments are concerned about ‘social welfare’, they should be concerned with both kinds of shocks.

So the moral responsibility argument is not always easy to sustain. Another, more decisive, argument for distinguishing the two, is that governments may not have as much advance information of the market-based shock as of the policy-induced shock and may not therefore be in a position to intervene *ex ante* in the former case. But that is a practical, not a logical, constraint and it does not apply *ex post*.

The above discussion leads us to two conclusions:

- When examining the case for *ex ante compensation in response to a particular shock*, one should realistically expect governments to be mainly concerned with government reforms. So the rest of this section and the next are principally concerned with structural and distributional change which is policy-induced.
- However, we would expect governments to be equally concerned about market-induced changes when they review the *cumulative long term distribution outcomes of structural change ex post*. So section 3.5 takes a broader view of government responsibilities.

Should other policy distinctions be attempted?

Another question asked in the Commission's brief is whether one should make a distinction between *broad framework changes*, such as tax and industrial relations and *industry-specific changes*, such as trade liberalisation and new specific competition provisions. It is hard to see the logic of such a distinction.

We suggested in section 3.3.3 that government intervention should be quarantined to shocks which have concentrated regional effects or impact strongly on the poor and on levels of inequality. But this is a distinction which cuts across the 'industry-specific' versus 'broad framework' distinction. Industry-specific changes are not necessarily more regionally disruptive than broad framework changes. Thus, a change in protection or level of assistance which rocks, say, the pharmaceutical manufacturing industry may have fewer regional implications than, say, a broad-based tax reform package which impacts heavily on mining. Similarly, a pharmaceutical industry shake-up is likely to have much less worrying implications for the poor than say across-the-board wage deregulation (assuming no compensation in both cases).

True, losers would, in general, be easier to identify when an industry-specific policy change is made than when a broad framework change is made, so compensation would be easier to implement in the former case. But that again is a practical issue and does not provide a logical reason in principle to start with such a distinction.

Where should onus of proof lie?

The Commission asks whether the onus of proof should rest with advocates of reform or defenders of the status quo. The former approach could hold up reform and the latter could mean that distribution effects received inadequate attention.

This is a difficult issue, but Australia's political system seems to have found a neat compromise. Governments have resources, expertise and enormous authority (not to mention an ability to manipulate public opinion and the media). This gives them an advantage in marketing a proposed reform. On the other hand, given our bicameral system and the tendency for minority groups to control the Senate, the onus of proof tends to rest with advocates of reform whenever legislation is required. We saw this in the case of GST and unfair dismissals legislation.

In my view, this is no bad thing even if it means delaying the reform by a few months or longer. If a Government, with all its enormous authority, resources and marketing advantages, cannot clearly and convincingly show how a reform will

make the great bulk of Australians better off within a reasonable period of time, then it probably means that the distribution effects have not been well thought out.

3.3.4 Efficient methods of targeted ex ante intervention

Having decided that the distribution shock warrants ex ante intervention and that at least the losers can be identified so that the benefits are not wasted on unintended ‘outsiders’, how should the targeted compensation be designed? Such compensation can take two distinct forms — adjustment assistance and financial compensation. The latter seeks to restore the income or assets of losers. Adjustment assistance goes further and provides incentives to change behaviour eg to re-skill or move to other areas. In various parts of the paper, we have already hinted at what are good and bad methods of targeted intervention. We now try to collate our views in this subsection.

In my book, I outlined some conditions which need to be met to ensure ‘efficient and effective compensation’ (Argy 1998a, pp. 115–6). They include the following:

- the method of compensation needs to be transparent to ensure accountability and, if necessary, regular review;
- the administration costs of the compensation process must be low relative to the total compensation amount;
- the instrument used must not generate too many by-product market distortions;
- the compensation policies should not simply provide passive support, but (where appropriate) should aim to facilitate labour market adjustment (eg mobility assistance and the acquisition of skills and characteristics required for labour market integration).

The precise compensation tool to be used will depend on the circumstances of the losers. The losers fall into four categories:

- (i) those who are displaced, retrenched or lose business when an industry declines (as a consequence of, say, competition, tariff reform or public sector down-sizing) in a region dependent on that industry;
- (ii) those who initially have to pay higher prices for services received (as in cases of privatisation, commercialisation or deregulation of public utilities);
- (iii) those who become more exposed to wage cuts (as in labour market deregulation); and
- (iv) those who suffer directly from a restructuring of the tax and welfare system.

In the case of (i), the compensation could take the form of job search, retraining and mobility assistance (over and above that already available under existing policy). If the region is one which appears to have long-term economic viability, the compensation could also include some regional support. The support could take the form of tax incentives or wage subsidies to attract new investment, the financing of new productive infrastructure with large potential spin-offs, backing of local regional initiatives or the relocation of government departments.

In the case of (ii), compensation could take the form of vouchers, direct social security supplements or special exemptions by arrangement with the service provider. The ‘value capture’ method could also be used.

In the case of (iii), the desired results could be achieved through a combination of earned tax credits and targeted wage subsidies.

In the case of (iv), direct compensation measures, such as those proposed by the Howard Government for the GST package, could be considered. Otherwise reform offsets must be sought. Thus a tax reform such as a GST replacing income tax could be associated with a wealth tax or a tightening of capital gains tax provisions and more generous social security supplements. This option is discussed in the next section. We have focused in this section on targeted intervention techniques where winners and losers can be roughly identified.

3.4 Other possible form of ex ante social smoothing

Suppose winners and losers cannot be easily identified, even in a rough and ready fashion, and so *targeted ex ante* intervention is not feasible. Suppose also the distributional shock is large and warrants policy concern and the Government wants to do some general social smoothing *ex ante*. How should it proceed? There are two options: log-rolling and reform dilution.

3.4.1 Log rolling

Log rolling, ie the notion of introducing a set of ‘complementary’ reforms in tandem, is often applied to cases where one set of reforms is introduced in conjunction with another in order to enhance the *economic effectiveness* of the latter. For example, labour markets are deregulated at the same time as the financial system is being deregulated and trade barriers are being dismantled in order to make the latter reforms work more quickly and smoothly. In this paper, however, log rolling is used in the sense of introducing one set of reforms in tandem with another in order to soften the social impact of the latter. Log rolling is one way a

government can be seen to be making a genuine attempt up front to spread evenly the costs and benefits of economic reform. For example, the effects of the Hawke Government's brave economic liberal reforms of the 1980s were tempered by some progressive tax reforms (such as on capital gains and fringe benefits) and, more importantly, by improvements in family assistance. (It is estimated that a low-income family received five times more assistance in real terms in 1995-96 than in 1982-83 (Harding and Beer 1999).)

The wage/tax trade-off proposed by five economists led by Peter Dawkins (Dawkins, Freebairn et al. 1998), by Argy (1998a, pp. 147-8) and by the BCA (1999) all seek to restrain aggregate real wages (through a freeze or real cut in the safety net minimum wage), but matched by earned income tax credits for low-paid workers. If that is all that was involved, it would be a good example of targeted compensation of the kind discussed in section 3.3. However, the Dawkins/BCA packages include other elements — including a growth strategy (through better macroeconomic management), a broader and more systematic approach to labour market programs targeted at the long term unemployed and greater support for the education and training of individuals over their life cycle. In that sense it involves log rolling in the sense used in this section.

The package as a whole is intended to achieve its desired employment goal with equity. Whereas the pure labour market deregulation option (advocated by hard liberals) puts the whole cost of reducing unemployment on low-paid workers, this package spreads the cost among taxpayers as a whole. Therein lies its great merit.

Perhaps the Five Economists package does not fully protect all low-paid earners. Perhaps it does not adequately deal with the regional dimension of unemployment (it does not suggest any differentiation between regions in the living wage adjustment). Perhaps it uses a rather blunt instrument to achieve the desired improvement in unemployment — in that it relies heavily on a cut in real minimum award rates at the bottom end to lever down aggregate wages (with uncertain effects on aggregate unit labour costs and inviting substitution effects). Moreover, there are fiscal and institutional constraints on how far one can go in reducing the minimum wage. So it is not clear how effective the Five Economists' proposal will be (Gregory 1998), but it is a good try and entirely consistent with the thrust of this paper.

The kind of log rolling envisaged in my book (Argy 1998a) is more wide ranging. For one thing, the package I propose includes a much bigger role for labour market programs (wage subsidies with training, work experience and case management) than seems to be envisaged by the Five Economists or the BCA. The main aim of these programs is to specifically target the long term unemployed and help reduce

the NAIRU. It would also, in the long run, reduce welfare dependence by raising the productivity and employability of the long term unemployed and help them to secure higher wages over time, instead of being chronically dependent on welfare or tax credits. There is evidence that wage flexibility work much better in conjunction with labour market programs than on their own (Argy 1998a, p. 196).

As well as aggregate wage restraint, tax credits and active labour market programs, an integrated employment-promoting consensus-building package should also contain:

- a regional strategy designed to improve the geographical spread of employment opportunities and take the pressure off our cities;
- a bigger medium-term investment in productive and social infrastructure financed in part through private finance and, in part, (where the risk is best borne by government) through public sector borrowing (subject to maintenance of public sector net worth);
- a limited job levy to create jobs for young unskilled workers in services, including community and public services;
- a less timid approach to managing demand when unemployment is on the rise and a more realistic policy assumption about the sustainable unemployment and growth rates; and
- some revenue raising measures which have a broad offsetting effect on distribution (eg a broadening of the existing income and capital tax base).

Such a package would amount to full-blooded log rolling. Its rationale is that it would achieve a bigger unemployment reduction with more equity. Whether it would appeal to politicians is another matter.

3.4.2 Reform dilution and the equity/efficiency trade-off

Another option open to governments is reform dilution (slowing or watering down a reform program). In general, governments should not obstruct desirable structural reform simply in order to avoid the social effects. It is far better to allow change to proceed and then try to temper the harsh effects of the markets through direct tax or transfer instruments. In fact, good instruments of redistribution should try to facilitate longer term adjustment, a point we develop in section 3.5.

If, however, it is not feasible to temper the social effects of markets, governments should look again at the reforms themselves and the scope for trade-offs.

There are two distinct trade-offs relevant to this workshop. The first is between employment and equity and the second between efficiency and equity.

An employment/equity trade-off can arise for various reasons:

- many believe that wide earnings dispersion is a pre-condition for low unemployment (Jackman 1998; Katz 1998);
- many also believe that one can have regular living wage increases only at the cost of higher unemployment (employers and government submissions to the Industrial Relations Commission); and
- a very high social wage, broadly defined to include both cash benefits and other social transfers such as free medical care (ie one which is generous relative to the net wage payable to the least advantaged worker), is often seen as incompatible with low unemployment (Boix 1998).

Similarly, an efficiency/equity trade-off can arise for many reasons:

- business regulation of the work place and a strong trade union movement protected under the law can sometimes impede managerial flexibility and productivity but they protect low-paid workers;
- consumer protection regulation inhibits efficiency but is helpful to unsophisticated (generally poor) consumers;
- a trade liberalisation initiative may impact positively on output in the longer term but aggravate the regional imbalance of employment and incomes, at least in the short term; and
- a tax reform which flattens income tax schedules may promote simplicity, reduce compliance costs and tax avoidance and enhance the supply of risk capital but is bad for vertical distribution equity.

Such trade-offs sometimes lend themselves to simple resolution. Thus, if the adjustment costs and distribution effects are small and the potential efficiency gains large it might be best to simply ignore the former. This may apply, for example, to the removal of certain restrictive practices in the workplace (unrelated to health or safety), or to a rationalisation of the indirect tax system which leaves the tax mix unchanged or a change in the corporate tax structure which removes many archaic business deductions and concessions in return for a lower corporate tax rate.

Conversely, if the adjustment costs are high and/or the long term distribution effects very regressive, but the efficiency gains are small or at least uncertain, it is best not to proceed with the reform at all. An example of the latter would be a policy reform like a marked reduction in all prescriptive occupational health and safety regulations, or an attack on the basic rights of trade unions. Again, a reform of the

social security system involving a reduction in benefits available to certain long term unemployed (a policy which this Government seems to be leaning towards) in order to force them into searching more actively for jobs is socially devastating. Yet it has little merit on economic grounds in a country like Australia, as there is no reason to believe that an appreciable proportion of the unemployed are job-shirkers (Argy 1998a, pp. 35–6, 100–4). In cases such as these, where the efficiency gains are small, it makes sense to modify the reform itself even if losers can be identified and compensated, as the redistribution process may involve an efficiency cost greater than the efficiency loss from modifying the reform.

Most reforms are not as easy to resolve as the ones discussed above and require a significant sacrifice of either efficiency, employment or equity. Suppose, to take a rather stark example, some economists were to convince the Government that a major reduction in government spending (including on ‘social wage’ items), coupled with more comprehensive business deregulation (including, say, a sharp reduction in minimum wages and a relaxation of consumer protection regulation), would increase real GDP per head by 5 per cent over the medium term. Suppose also it was clear that such a reform would lead to a marked increase in inequality, both of incomes and quality of life, across the community but the lack of information and the fiscal cost made any attempt at targeted compensation impractical.

In such circumstances, if a Government were concerned about the distribution effects but did not want to reject the reform path outright, it could embrace ‘reform dilution’. That is, it could:

- postpone the reforms for a few years, but give notice of intent so that everyone had ample time to adjust;
- phase in the reforms gradually over a long period; or
- modify the reforms (make them less socially unacceptable).

All these options have their place. Take, for example, compulsory competitive tendering of traditional council services to private sector competitors. This appears to be having seriously disruptive effects in some regions, both in terms of jobs and services available (Washington 1999). In such circumstances, with targeted compensation and log rolling options likely to be limited, a strong case can be made for gradualism in implementation.

Compromises may produce ‘second best’ outcomes for either efficiency or equity or both. But they may well be optimal for social welfare. It is better of course to look first for win/win solutions but if they are not available or usable it is legitimate to turn to such compromises as a last resort. The important point, as I argue in my

book, is that ‘trade-offs between output gains and welfare gains should be an integral part of economic policy formulation and should be done up-front, not as a separate exercise’ (Argy 1998a, p. 62). If it is not done up front it may never happen because once the reforms have gone ahead the scope for trading off output becomes logistically more limited and entrenched reforms are harder to dislodge.

No economist can lay down firm rules on trade-offs involving efficiency, employment and equity. It is in the political arena that decisions to compensate or otherwise intervene ultimately have to be made. Economists can only help politicians make choices by assessing the distribution effects and quantifying the efficiency or employment benefits.

3.5 Ex post social smoothing: processes and principles

As already noted, some reforms can pose serious risks for income and wealth distribution in the long term, but the winners and losers are hard to identify even in a rough and ready manner — at least ex ante. This is true of financial deregulation, broad-ranging shifts in trade and competition policy and many forms of labour market deregulation (those which involve greater wage flexibility, cutting jobless benefits, relaxing worker protection and eroding the rights of trade unions).

In such cases, tightly targeted adjustment assistance or compensation of losers is not a viable option. If a government also rules out the other two options for ex ante smoothing discussed in section 3.4 — viz. diluting the reforms; or trying to introduce other reforms in tandem — the only form of social smoothing available is ex post redistribution a few years down the road. As noted in section 3.3.3, such policies would have to be directed at both government-induced and market-induced structural change as the two are hard to separate (observed movements in social indicators would reflect both the impact of past reforms and the associated impact of market-induced technological and structural developments).

In this section, therefore, we discuss first the processes which could be put in place to carry out the ex post redistribution and secondly the appropriate instruments of redistribution. It is an attempt to answer the key question posed by the Commission in its brief for this workshop, viz. that if redistribution is considered appropriate, ‘what form should it take and on what terms, having regard to potential efficiency costs?’. The question was partly answered in the context of targeted compensation in section 3.3.4. Here, we deal with it in the context of ex post redistribution.

3.5.1 Processes

Governments could decide to proceed with every reform which clearly improved efficiency and then review the social outcomes periodically, say every three to five years, by systematically collecting and analysing a broad range of social indicators on a regular basis.

To achieve the aim of social harmony and to create a climate conducive to economic reform, the ex post redistribution strategy should be spelt out in advance (ie at the same time as the reform program is announced). The government would announce which social indicators it would monitor, which outcomes it would consider unacceptable (its social goals) and what action it would take to redress the situation if it proved unacceptable. The commitments could even be built into legislation and hopefully agreed on a bipartisan basis.

Once the goals were defined, it might make sense to ask the Productivity Commission (assisted by appropriate people from welfare and community organisations) to perform the monitoring function as part of its inquiry program. Its role would be to advise the Government on the perceived social trends and how they diverged from the defined social goals, and to propose cost-effective and efficient methods of achieving the desired goals (through social security, tax, labour market and regional policies among others).

Some might even want to go further and set up a semi-judicial body with statutory powers to enforce its findings and conclusions. This would be an extension of the idea (favoured by financial market gurus and hard liberals) of having independent agencies acting as constraints and disciplines on government in fiscal and monetary matters — only in this case it would apply to the social arena. However, there are dangers in eroding our parliamentary democracy in this way, whether to impose financial, economic or social disciplines on governments.

3.5.2 Efficient and effective methods of redistribution

Neo-liberal opposition to redistribution is partly driven by a particular set of values, but it also derives from a genuine concern about the effectiveness and efficiency costs of redistribution policies. It is important to address these concerns. If instruments of redistribution are ill-directed, wasteful or if they generate inefficiencies which negate the benefits of structural reform, they can prove counter-productive.

We argued in section 3.2.3 that — provided sound and sensible instruments are used — neither theory nor empirical evidence support the view that socially progressive

policies necessarily impair economic performance. In section 3.3.3, we outlined some efficiency criteria for targeted social smoothing ex ante. In this section, we outline the criteria for ex post social smoothing.

Along similar lines to section 3.3.3, we will argue that the economic costs of longer term redistribution can be minimized or even neutralized if:

- (a) the instruments used are cost-effective (ie achieve their social aims at the least possible financial cost);
- (b) governments intervene in ways which supplement, rather than replace, markets and so do not have a significant impact on allocative efficiency;
- (c) every effort is made to reduce the risk of welfare dependence; and
- (d) the measures seek not only to provide passive welfare support, but also to promote equal opportunity and facilitate long-term personal adjustment.

This section now discusses each of these guiding principles in turn.

Cost effectiveness

Interventions aimed at soothing short term pain or at broad long term redistribution must be consistent with sound public management principles. That is, the instruments must be administratively simple and economical, well targeted, transparent (to ensure accountability) and subject to regular review. As well, the social objectives of the intervention need to be clearly defined and spelt out so that the intervention does not set undesirable precedents — eg inviting the wrong kinds of rent-seekers seeking similar treatment.

In the last 15 years, much progress has been made in improving the cost-effectiveness of redistribution mechanisms (although many believe that in the process there has been some sacrifice in quality of service). Perhaps more can be done to streamline the delivery of welfare services and make them more client-friendly through:

- better specification of goals and outputs;
- greater opportunities for competitive tendering and involvement of the private sector; and
- greater decentralisation of service delivery (eg through local authorities and locally-based voluntary social organisations and with greater involvement and participation of family support and community groups).

Mark Latham (1998) sees public provision of assistance being reciprocated by personal family and community responsibility; and there is merit in that idea

provided it is designed to supply services *where none previously existed*. (Note for example, the recent establishment in Campbelltown, NSW, of networks to help families with developmentally disabled kids (Botsman 1999)). It is fanciful to think one can fairly, and in a cost effective way, shift responsibility for social security from government to families. East Asian governments relied heavily on families and this worked for a time in a favourable cultural and economic environment. But it is now under great stress.

Concerns about ‘the demographic time-bomb’ and associated increases in the tax burden have also triggered bold and sweeping reform proposals for a compulsory contribution-based system (eg Fitzgerald 1998; Modigliani 1999; Orszag and Snower 1997). Many of these ideas have merit but they present formidable transitional (phasing in) problems for funding and for intergenerational equity and require special provisions for low income people who cannot build up adequate capital.

Moreover, it is arguable that the underlying concern about the impact of Australia’s ageing population (after 2015) on future budgets is exaggerated. This concern is based on projections which embody over-conservative estimates of productivity growth, household saving rates and labour participation rates (especially of older people). And it assumes no change in retirement policies (eg in the incentives to postpone retirement, the preservation age, the treatment of lump sums, or compulsory employee provisions).

Supplementing rather than replacing markets

Good redistribution instruments should not interfere with efficient markets or have distorting effects on resource allocation. Bad instruments of social policy include, for example, the use of financial controls, trade protection, government ownership or subsidies on food and other necessities. Some of these instruments are blunt. For example, the World Bank (1998b) found that *universal* subsidies have almost always proved to be highly ineffective in reaching the poor as well as being fiscally unsustainable (The micro-efficiency merits of targeted relative to universal subsidies are less clear). Even more importantly, regulatory instruments have well-known secondary by-product effects on resource allocation which further reduce social welfare (Corden 1974). Similarly, extensive use of labour market regulation (eg setting very high minimum wages), to promote a fairer distribution of incomes is not only of limited effectiveness (Richardson and Harding 1998), but also counter-productive for employment (Dawkins 1998).

Instead of such blunt, indirect and mostly inefficient instruments, it is generally better to use well-targeted budgetary instruments which are directed as closely as possible to the purpose in hand.

While economists accept this as a general proposition, they have become increasingly aware that use of the tax/transfer system for redistribution, while likely to have fewer resource distorting effects, can have other undesirable economic efficiency effects (eg on saving, investment, innovation and employment). Although these incentive costs have been exaggerated (as we noted in section 3.2.3), there is a challenge here to design the compensatory measures in a way which minimizes such costs.

The criteria usually considered desirable in a tax system are well known (Freebairn 1998). They include that it should have a neutral effect on economic choices of households and businesses, give equal treatment to equals (horizontal equity), impose a lower burden on people in the lower and middle income groups (vertical equity) and offer simplicity in both administration and compliance.

Against these criteria, some of the more obvious sources of additional revenue for any increased redistribution effort would be income tax base broadening measures (including a more vigorous attack on tax evasion) and increased taxes on immobile capital, such as land and similar forms of personal net wealth and taxes on wealth transfers, such as inheritance duties (Head 1998). Such taxes have only minor work disincentive and dead-weight resource misallocation effects.

Nor should we fear a modest increase in the top marginal tax rates. Indeed, if associated with an attack on poverty traps at the lower end (eg through lower tax credits), a more progressive income tax system could actually have a net positive effect on work effort, as labour supply elasticities of high income earners tend to be lower than those of low earners (Apps 1997; Argy 1998a, ch. 6).

Similarly, social security changes must be designed so as to minimize undesirable effects on work incentives, but this is discussed separately under welfare dependence below.

All that said, there are times when the most economically efficient way to deal with an undesired distribution effect (ie the way which will maximize social welfare) is through regulation. For example, an economic case can be made for using legislation to protect certain basic workers' rights and working standards. Few question the need for regulation to protect freedom of association, outlaw child labour, discourage various discriminatory practices based on race, gender or ethnicity, and to safeguard occupational health and safety. Equally one can argue that adequate redundancy notice and retrenchment payments, a decent minimum

wage and working conditions are not only essential elements of an effective social infrastructure but have strong economic merit as well.

Such protective measures can do much to make economic reform more acceptable, help preserve social harmony which, in turn, has economic implications, as we noted in section 3.2, and they can make a positive contribution to worker morale and productivity. Just as excessive labour protective measures can be counter-productive for the poor (especially if the regulations interfere unduly with functional and organisation flexibility at the enterprise level), so too excessive meanness in this area can be counterproductive for efficiency.

Minimising welfare dependence

Good redistribution instruments should minimise the risk of welfare dependence. Some believe this requires a smaller, less generous welfare system to increase the financial incentive to work (Kasper 1998). This view is debatable, especially for a country like Australia which has in place extremely tough work tests and unemployment benefits (although open-ended) which are not high relative to the minimum wage. It is a view I vigorously challenge in my book (1998a, pp. 33–6, 100–4). A recent comprehensive review of the evidence concludes that ‘the hypothesis that unemployment benefits exert a substantial upward effect on the level of unemployment receives little empirical support’ (Barr 1999, p. 16).

Nonetheless, social progressives recognise the dangers of allowing a culture of welfare dependence to develop. They are aware of a growing disenchantment with welfare and a backlash against some welfare recipients such as dole recipients and single parents. There is a need to rebuild public support for the welfare system.

Welfare dependence can be reduced by ending the claw back of lower middle class welfare and by dealing vigorously with poverty traps. Poverty traps, in particular, are the subject of much current debate. I have argued for US-style earned tax credits as a means of reinforcing financial incentives to work (Argy 1998a). Negative income tax arrangements, while still in the design stage in most countries, are also worth considering for the long term (they are part of the Five Economists’ package).

Perhaps more can also be done to promote genuine reciprocal responsibility (mutual obligation). But increased obligations on support recipients must be matched by increased obligations by the community (government). There is nothing to be said for governments implementing alienating and punitive measures against those on welfare and forcing them to undertake activities which will do little to help their long-term position — while doing nothing extra to improve the competitive ability of vulnerable people in the labour market and helping them to become productive

members of society. Work-for-the-dole schemes, in their present form, are subject to such criticism, although they have a role if they are well-designed. We should look for a model in Working Nation, which involved the offer of a job or training for long term unemployed, with a loss of unemployment benefit for a period if the offer was refused.

The most fundamental way to reduce welfare dependence is to address the root causes of poverty — unequal opportunity.

Facilitating long-term personal adjustment through equal opportunity programs

One way to reduce welfare dependence is through measures which prevent long term unemployment and poverty through early public intervention to enhance the opportunity for self-advancement — what can be called equal opportunity programs. This means more emphasis on promoting life-cycle education and training (which is also economically rewarding) and effective labour market and regional programs, while ensuring that ownership of wealth (especially incremental wealth) is not unduly concentrated.

The need to broaden access to education is widely accepted. In my book, I emphasize the role which *primary education*, especially support for disadvantaged children in these schools, can play in lifting poor children out of poverty (Argy 1998a, pp. 120–1) and there is now strong evidence to support this view (World Bank 1998a, 1998b). As well, targeted subsidies to encourage students in secondary school to stay on can pay off socially and economically.

As well as education, we have already stressed the role of labour market programs in enhancing equal opportunity — especially training and mobility promoting schemes, wage subsidy programs, case management for long term unemployed and the like. Such programs should be supplemented by active efforts to even out regional employment opportunities and relieve urban congestion.

There is no logical reason why well chosen, well targeted labour market and regional programs cannot be just as effective in reducing long term, structural unemployment as labour market deregulation. The former relies on productivity increases, wage subsidies and a better spread of employment opportunities, while deregulation (over and above improving functional flexibility) relies essentially on improving wage relativities and downward wage flexibility. In both cases, the net employment response is muted. It takes a big reduction in relative wages of low paid workers to achieve a substantial net reduction in aggregate structural unemployment. And it takes expensive labour market programs to achieve the same result. In both cases there are efficiency costs — from higher taxes in the case of

active programs and from poverty traps in the case of wage flexibility. The only real difference is that wage cuts have the potential to make the distribution of incomes much more unequal, whereas labour market programs on balance are progressive in their impact.

But do labour market and regional programs work in practice? The results are mixed but I argue in my book that if carefully designed and well implemented, they have been found to be effective and in the long term pay for themselves (Argy 1998a, ch. 10). Recent literature does not contradict this conclusion.²

This is not to say that labour market and regional programs are a sufficient response on their own. They should be part of a broader strategy which includes: a degree of flexibility in relative wages, adequate financial incentives for the unemployed to find work and a framework for restraining aggregate wage outcomes in times of high employment. Nonetheless, labour market programs deserve pride of place in this overall strategy because of their potential to reduce social inequality as well as reduce unemployment and improve productivity, whereas some of the alternative policy options have painful trade-offs between efficiency and equity and involve perpetuating a low wage culture.

Another dimension of equal opportunity policy requiring attention relates to urban infrastructure and especially public transport and other community services in outer suburbs where poor families live. Difficult living conditions mainly impact on the relatively poor and are a great source of injustice. There is also a clear economic cost in poorly functioning cities.

Social exclusion of certain categories of people, especially the poor, can occur through inadequate access to the credit market, the legal system and electronic information. All these need attention as part of an equal opportunity package.

An active equal opportunity agenda would be a sound investment in the economy and society, but would cost money. We have already indicated the kinds of revenue-raising options which would have little, if any, economic cost (eg wealth-based taxes would serve the dual purpose of improving the revenue base and contributing to genuine equal opportunity).

It is also time governments (state and federal) tried to explain to the community that moderate net government borrowing over the economic cycle to finance new social infrastructure is not the devil it is made out to be.³ Such infrastructure investments (hospitals, educational institutions, public transport and community services) have substantial 'externalities' relative to investments which produce commercial returns. They are also of special benefit to the poor. The present excessively conservative

fiscal stance of state and federal governments is creating a bias against both efficiency and equity.

Provided tax and borrowing policies are not carried so far as to frighten off long-term capital, and provided it is all happening in an environment which is conducive to structural change and productivity growth, and the measures are well explained, there is no reason why a more ambitious equal opportunity agenda should impact adversely on financial markets and economic performance, even in the short term.

That said, unfettered international financial markets can have a malign economic and social effect at times, and there is an urgent need for coordinated international action on two fronts. First, an effort should be made to reduce the instability of short term capital flows — through better prudential supervision of banks, improved corporate disclosure rules, more transparency, more effective insolvency laws, better international surveillance and the development of more stable exchange rate regimes.⁴ Second, there is a strong need for an international social pact which integrates the principles of free trade and free capital flows with the kinds of principles on which the EU Social Charter is based. The aim would be to minimise the risk of competitive cuts in social and worker protection standards (ie effectively ‘social dumping’) as part of the competition for markets and mobile international capital (Argy 1998a, p. 119).

3.6 General conclusions

This paper began (section 3.2) by reiterating three key themes of my book:

- Governments should try to ensure that the incremental costs and benefits of economic reform and structural change are widely shared (social smoothing). An economic reform program purely targeted at maximising efficiency, GDP per head or economic freedom without regard for distribution will almost certainly fail to maximize economic welfare.
- Social smoothing is compatible with a strong economic performance — provided it is pursued with *moderation and with sensible redistribution instruments*.
- To a considerable degree, the choice between ‘soft’ and ‘hard’ approaches to economic reform is still open to Australians. Those who claim there is only one way — the hard way — are expressing their normative values rather than engaging in economic debate. This does not mean that the issues are all about ends rather than means. As this workshop will demonstrate, there is much economists can still argue about even if they start with different value judgments.

Having got this fundamental issue out of the way, the rest of the paper (sections 3.3 to 3.5) has been concerned with *how* social smoothing can be implemented practically, effectively and efficiently. In particular, it has sought to address the specific questions posed by the Productivity Commission on how the policy evaluation and implementation process can best deal with the adjustment costs and distributional consequences of reform and structural change. With this as its main intent, the paper has reached the following conclusions.

1. Where possible, social smoothing should be done *ex ante* and specifically targeted. While there are both technical and political impediments to the implementation of targeted adjustment assistance or compensation, there are many cases where winners and losers can be roughly identified and where such intervention is feasible (sections 3.3.1 and 3.3.2). Even in such cases, it does not follow that every individual reform which has a significant distribution effect should be accompanied by adjustment assistance or targeted compensation. The paper argues (section 3.3.3) that:
 - governments need to intervene selectively, focusing on big region-specific or regressive distribution shocks;
 - in assessing distribution effects governments should where possible look at reforms not in isolation but as an integral package;
 - the distribution effects of a reform program need to be compared with the likely distribution outcomes under alternative scenarios, including the do nothing option; and
 - there is a practical argument for focusing mainly on policy-induced changes when considering *ex ante* targeted compensation, but the distinction between policy-induced and market-induced changes is meaningless when considering *ex post* social smoothing.
2. When *ex ante* targeted intervention is considered both feasible and appropriate, there is need for care to ensure the method of compensation is effective and efficient — ie transparent, easy to administer, non-distorting and facultative of labour market adjustment. The precise compensation tool (mobility assistance, wage subsidies, direct social security supplements, tax concessions etc) will depend on the circumstances (section 3.3.4).
3. If, as is often the case, it is not feasible to target losers specifically. two alternative *ex ante* approaches are available. One would be to introduce ‘distribution-friendly’ economic and social reforms at the same time as economic liberal policies are introduced — what has been called ‘log rolling’ (section 3.4.1). Another would be reform dilution, ie trading off some efficiency (eg by phasing, deferring or diluting some policy reforms). Dilution should be

done up front and should be viewed as a last resort option when all other forms of ex ante smoothing fail (section 3.4.2).

4. In the end, the scope for ex ante social smoothing may be limited so it is desirable to complement it with ex post social smoothing, to ensure the benefits of economic growth are widely shared. If a government chose to rely heavily on ex post social smoothing, it would be important to have a consistent implementation framework so as to avoid political ad hocery and to build in various safeguards against 'government failure'. In this context, it would be vital that the government define its social goals precisely and that an independent body like the Productivity Commission be given the role of:
 - reviewing social developments;
 - reporting to the government on how closely the social goals were being achieved;
 - identifying distribution data deficiencies and how these could be corrected; and
 - pointing out the most cost effective and efficient methods of redressing social inequities (section 3.5.1).
5. The paper sets out some views on appropriate long term redistribution instruments, stressing the need to ensure the instruments:
 - are cost-effective;
 - supplement rather than replace markets;
 - minimize the risk of welfare dependence; and
 - promote equal opportunity.

A3.1 Incidence of poverty in Australia

Any discussion of poverty in a country like Australia does not of course relate to *absolute poverty* — the minimum subsistence level (which in a warm climate is perhaps only a few dollars a day). Rather it refers to *relative poverty*, ie relative to community norms. A household is living in relative poverty if it is earning an income which is:

- (i) inadequate to meet socially perceived necessities (comfortable shelter, a phone, a TV, healthy diets, occasional recreation such as going to the football and movies, ability to maintain minimum health standards, occasional new clothes etc.);
- (ii) inadequate to allow families, with frugal and careful management, to participate effectively in every day social activities in accordance with community expectations; and
- (iii) so low relative to the median, that it robs people of pride and dignity.

The poor in this relative sense have been measured three ways:

- (i) those below the Henderson poverty line (which rises with community living standards);
- (ii) those below, say 50 per cent of average or median equivalent income (which is below Henderson); and
- (iii) and those below an independently determined low-cost, austere but decent budget standard (which tends to be in line with Henderson).

On all the evidence (as set out in Argy (1998a, pp. 24ff.) and more recently in Bradbury and Janiti (1998); Harding (1999); Saunders (1999a)), the following conclusions can be drawn:

- Whichever of the three measures is used, at *least 10 per cent* of all Australians (and some 20 per cent of young single people and single parents) still live in poverty.
- Some of the measures suggest that over the last 15 to 25 years, there has been an increase in the ‘rather poor’ category although not in severe poverty. While the bottom 20 per cent and top 30 per cent of households enjoyed appreciably higher real after tax incomes, the 40 per cent of households in the middle of the income distribution, and especially those in the relatively poor 3rd to 5th income deciles, have faced a sharp decline in real disposable needs since the early 1980s.
- Some measures also suggest that relative poverty in Australia is high relative to European countries and second highest after the United States. This is true for

example of child poverty (using a poverty line based on 50 per cent of median equivalent family disposable income).

Not all the poor in Australia are unemployed. Increasingly they include many on paid work (Mike Steketee, *Weekend Australian* 27-8 February). The worst areas of poverty are amongst single unemployed persons and single parents who are renting, as well as among special groups like aboriginals and newly arrived migrants.

We know that poverty in families affects the capacity of children of those families to become upwardly mobile. So there is self-perpetuating cycle of poverty within families from one generation to the next.

Endnotes

¹ See Argy (1998a, ch. 1). Since the publication of the book, Steve Dowrick (PC and ANU 1998) has shown that Australia's productivity growth has accelerated by over 1 per cent of GDP in the 1990s whereas it has slowed down in most other countries. However, he remains agnostic about the role played by microeconomic reform. In my view, microeconomic reform has been a significant factor behind Australia's improved economic growth in the 1990s but so has improved macroeconomic management. Equally, the disappointing economic performance of Europe and New Zealand in the 1990s has been due as much to poor monetary management as to ill-designed microeconomic reform.

² A new study which has emerged since my book (Stromback, Dockery and Yin 1998) throws further light on the benefits of labour market programs. It confirms that wage subsidy programs like Job Start have a positive impact on the chances of getting people into work and they also show that job creation programs such as Job Skills and New Work Opportunities perform a lot better than previous studies seemed to suggest. (On the other hand, surprisingly, they are less confident about some job search training programs like Job Clubs and SkillShare.)

Another recent OECD study (Martin 1998) presents a check list of active programs which appear to work well and those which do not. It singles out as positive those programs which:

- incorporate counselling, job-search assistance and public training for the long term unemployed and for those at risk of becoming unemployed;
- improve the job readiness of early school leavers;
- provide wage subsidies and entrepreneurial assistance;
- help to integrate the process of referring people to active programs with benefit and placement work; and
- make passive income support as 'active' as possible by using such instruments as re-employment bonuses, in-work benefits etc.

Its general conclusion is that such policies, if properly designed, can be a useful component of an overall labour market strategy but they are not a 'magic bullet' solution to unemployment in their own right.

Professor Bruce Chapman also recently revisited the topic. Using a dynamic three-period flows model of unemployment, he concludes that 'there is a very large variance in the effects of labour market programs on both employment creation and the budget'. In particular he expresses doubt that increased formalized education — specifically an extra two years at school — will do much for *short-term* net job creation. This new finding does not mean that enhancing education is not helpful for the labour market in the *longer term*. By better matching of skill needs and skill availability, education can help reduce structural unemployment over time (because those displaced are more likely to find re-employment quickly than those stigmatized as long-term unemployed). Nor does Chapman's new finding in any way compromise his earlier findings that wage subsidy programs such as Jobstart and other programs targeted at the long-term unemployed are a reasonably cost-effective way of reducing long-term unemployment (Chapman 1999; Piggott and Chapman 1995).

³ If a company is reasonably low-g geared (ie with a low debt to equity ratio) and has sound investment opportunities available to it, it would be reprehensible of that company *not* to borrow. Government borrowing should have similar tests applied to it. That is, governments must show that the proposed investment is economically sound; that it can best be financed by the public sector; and that their balance sheets are strong enough to bear an increase in debt.

To meet the first test, there needs to be a proper cost-benefit evaluation, ie with the cost of government capital measured in terms its opportunity cost not just the bond rate, and with wider

community and economic spin-offs taken fully into account. If it is found that the proposed investment offers relatively high social rates of return and that the ownership risks are such that they can be best managed by governments, then the first two hurdles have been successfully overcome.

Next is the balance sheet hurdle. It would be hard to argue that Australian governments are overloaded with debt or over-gearred. In fact they have a very low level of indebtedness relative to GDP compared with their counterparts overseas. We cannot assess gearing ratios because we don't have proper balance sheets (apart from 'trial' official estimates which have been severely criticized). In any case, the role of governments is to improve the *national balance sheet* even if it occasionally weakens their own net asset position.

But shouldn't we draw the line somewhere on public sector borrowings? Yes, governments need to be fiscally responsible in two senses. First, in general, governments should not borrow more than they 'invest' — ie they should aim to maintain or improve the nation's net worth. Second, the interest rate on public debt should never exceed the growth rate of GDP so that the debt servicing burden does not increase. All this implies a zero cash deficit only on recurrent budget not an overall cash surplus.

- ⁴ Needless to say a unilateral attempt to reincarnate exchange controls would not work in a developed economy like Australia; and would deny us the benefits of a clean floating exchange rate regime. Floating rates have given us more domestic monetary autonomy than would any alternative approach and have proved a good shock absorber in the recent Asian crisis.

References

- Apps, P. 1997, *A Tax Mix Change: Effects on Income Distribution, Labour Supply and Saving Behaviour*, Centre for Economic Policy Research Discussion Paper No. 371, Australian National University, Canberra.
- Argy, F. 1998a, *Australia at the Crossroads: Radical Free Market or a Progressive Liberalism?*, Allen & Unwin, Sydney.
- 1998b, 'Australia at the crossroads: radical free market or progressive liberalism? Key issues and conclusions', *Australian Economic Review*, vol. 31, no. 4, pp. 373–83.
- 1998c, Sambell Oration, Brotherhood of St. Laurence, Melbourne.
- Barr, N. 1999, Fundamentals of Social Security Analysis, R.I. Downing Lecture, University of Melbourne, March.
- BCA (Business Council of Australia) 1999, *New Directions*, BCA Discussion Paper, BCA, Melbourne.
- Boix, C. 1998, *Political Parties, Growth and Equality*, Cambridge University Press, UK.
- Botsman, P. 1999, 'The welfare future: families are doing it for themselves', *The Australian*, 10 March.
- Bradbury, B. and Janitti, M. 1998, *Child Poverty Across Industrialised Nations*, International Association for Researching Income and Wealth, Cambridge, UK.
- Campbell, H. and Bond, K. 1997, 'The cost of public funds in Australia', *Economic Record*, vol. 73, no. 22, pp. 22–34.
- Chapman, B. 1999, 'Could increasing the skills of the jobless be the solution to Australian unemployment?', Paper prepared for CEPR and ANU conference, Australian National University, Canberra, June 1998.
- Corden, M. 1974, *Trade Policy and Economic Welfare*, Clarendon Press, Oxford.
- Cox, E. 1999, 'Measuring social capital as part of progress and well-being', in Eckersley, R. (ed.), *Measuring Progress — Is Life Getting Better?*, CSIRO Publications, Collingwood.
- Creedy, J. and Dixon, R. 1998, 'The relative burden of monopoly on households with different incomes', *Economica*, vol. 65, no. 258, pp. 285–93.
- Dawkins, P., Beer, G., Harding, A., Johnson, D. and Scutella, R. 1998, 'Towards a negative income tax system for Australia', *Australian Economic Review*, vol. 31, no. 3, pp. 237–57.

-
- Dawkins, P., Freebairn, J., Garnaut, R. Keating, M. and Richardson, C. 1998, 'Dear John — how to create more jobs', *The Australian*, 26 October, p. 13.
- Eckersley, R. 1999, 'Perspectives on progress', in Eckersley, R (ed.), *Measuring Progress — Is Life Getting Better?*, CSIRO Publications, Collingwood.
- Economist* (various issues).
- Fitzgerald, V. 1998, 'Asia's alternative to crumbling welfare' *CEDA Bulletin*, March, pp. 14–15, 57.
- Freebairn, J. 1998, 'Taxation reform: some economic issues', in Head, J. and Krever, R. (eds), *Taxation towards 2000*, Australian Tax Research Foundation, Melbourne.
- Gregory, R.G. 1998, 'A summing up', *Microeconomic Reform and Productivity Growth: Workshop Proceedings*, Canberra 26–27 February, AusInfo, Canberra, pp. 413–29.
- Harding, A. 1999, 'Indicators of income inequality', in Eckersley, R. (ed.), *Measuring Progress — Is Life Getting Better?*, CSIRO Publications, Collingwood.
- and Beer, G. 1999, 'Effective marginal tax rates: options and impacts' *Centre for Public Policy Conference on 'Taxation Reform: Directions and Opportunities'*, 18 February, NATSEM, University of Canberra.
- and Szukalska, A. 1999, 'Trends in child poverty 1982 to 1995-96', *Australian Association for Social Research Annual Conference, 12 February*, NATSEM, University of Canberra.
- Head, J. 1998, 'Wealth taxation, capital income taxation and proposals for consumption tax reform', in Head, J. and Krever, R. (eds), *Taxation towards 2000*, Australian Tax Research Foundation, Melbourne.
- Henderson, I. 1999, 'High tax rate takes an unfair toll on workers', *The Australian*, 6 April.
- Holmes, S. and Sunstein, C. 1998, *The Cost of Rights*, Norton.
- Jackman, R. 1998, 'European unemployment: why is it so high and what should be done about it?' in Debelle, G. and Borland, J. (eds) *Unemployment and the Australian Labour Market, Proceedings of RBA Conference*, Reserve Bank of Australia, Sydney.
- Kakwani 1995, Discussion paper, in Industry Commission, *Conference on Equity, Efficiency and Welfare, Melbourne, 1–2 November*, pp. 98–103.
- Kasper, W. 1998, *Property Rights and Competition*, The Centre for Independent Studies Policy Monograph 41, Sydney.

-
- 1998-99, Kasper responds to correspondence (Argy), *Policy*, vol. 14, no. 4, Summer, p. 41.
- Katz, L.F. 1998, 'Reflections on US labour market performance', in DeBelle, G. and Borland, J. (eds) *Unemployment and the Australian Labour Market, Proceedings of RBA Conference*, Reserve Bank of Australia, Sydney.
- Krygier, M. 1999, 'A good society', *Eureka Street*, (January-February).
- Latham, M. 1998, *Civilizing Global Capital*, Allen & Unwin, Sydney.
- Martin, J.P. 1998, 'What works among active labour market policies: evidence from OECD countries' experiences' in DeBelle, G. and Borland, J. (eds) *Unemployment and the Australian Labour Market, Proceedings of RBA Conference*, Reserve Bank of Australia, Sydney.
- Modigliani, F. 1999, Letter to the editor, *Economist*, 3 April.
- Nahan, M. 1997, 'Economic freedom and the wealth of nations', *Institute of Public Affairs Review*, July.
- Orszag, M. and Snower, D. 1997, *Expanding the Welfare System: A Proposal for Reform*, Centre for Economic Policy Research Working Paper No. 1674, London.
- PC (Productivity Commission) and ANU (Australian National University) 1998, *Microeconomic Reform and Productivity Growth: Workshop Proceedings*, Canberra 26–27 February, AusInfo, Canberra.
- Piggott, J. and Chapman, B. 1995, 'Costing the job impact', *Economic Record*, vol. 71, no. 21, pp. 313–28.
- Rawls, J. 1971, *A Theory of Justice*, Harvard University Press, Cambridge, Massachusetts.
- Richardson, S. and Harding, A. 1998, *Low Wages and the Distribution of Family Income in Australia*, NATSEM Discussion Paper No. 33, NATSEM, University of Canberra.
- Saunders, P. 1999a, 'The role of indicators of income poverty in the measurement of national progress', in Eckersley, R. (ed.) *Measuring Progress — Is Life Getting Better?*, CSIRO Publications, Collingwood.
- 1999b, 'All things being equal, what's fair?', *The Australian*, 17 March.
- Solow, Robert M. 1997, *What is Labour Market Flexibility? What is it good for?*, Keynes Lecture 1997.
- Steketee, M. 1999, 'Poor fella our countrymen', *Weekend Australian*, 27–8 February.

-
- Stiglitz, J. 1998, 'Interests, incentives and institutions', *Policy*, vol. 14, no. 3, Spring, pp. 10–16.
- Strombeck, T., Dockery, M. and Ying, W. 1998, *Labour Market Programs and Labour market outcomes Paper*, Centre for Labour Market Research, June 1997. Also paper presented to 27th Conference of Economists 28 September to 1 October 1998.
- Washington, S. 1999, 'Private place in public space', *Australian Financial Review*, 24 March.
- World Bank 1998a, *Everyone's Miracle? Revisiting poverty and inequality in East Asia*, World Bank, Washington.
- 1998b, *Growth and Inequality*, World Bank, Washington.



4 Policy issues in structural adjustment

Malcolm Gray

4.1 Introduction and organising framework

This paper is one of a set commissioned by the Productivity Commission to provide a basis for a workshop on key issues in structural adjustment. The Commission provided a fairly specific and detailed brief, organised around three core policy questions (appendix A). The paper aims to address the questions outlined in the brief, but also to canvas some important related issues.

This section of the paper comments briefly on the context and objectives of the stream of work in the Commission of which this project is a part, before developing a framework in which to set the issues to be addressed. Two principal areas of interest are identified — policy evaluation and design, and issues arising from reform. Within the latter, four issues are identified: mustering political support for reform; the treatment of winners and losers; community concerns for issues extending beyond efficiency, such as equity; and dealing with the transition phase. The second section directly addresses the first of the three main policy questions posed by the Commission. This question stands somewhat apart from the rest, helping to set the context for the more specific and detailed questions that follow. The third section discusses the second and third questions, which cover the main substance of the issues. It looks at each of the four broad groups of issues (identified above) from first a policy evaluation and then a policy design perspective. The fourth section looks somewhat more broadly, particularly at issues raised by the evolution of reform processes. The last section presents some concluding thoughts.

4.1.1 Preliminaries

A variety of responses to public concerns required

This paper contributes to a project that is predicated on the observation that public resistance to change created by microeconomic reform has grown and that the concerns and confusion giving rise to this resistance may threaten socially

beneficial reforms. In the community there is seen to be questioning of whether the pain of reform is worth the gain and concern that adjustment problems are not being handled well, with those adversely affected by reform not being appropriately treated. Before moving to the topics this paper was commissioned to address, it is worth noting that other factors have also contributed to public disillusionment with microeconomic reform and that these too must be addressed to avoid threats to socially beneficial reforms.

Two areas where increased effort might be made are perhaps worth singling out. Selling the reform strategy, by identifying its objectives and demonstrating the linkages between the reform policies and those objectives, is vital, not only in building support to allow reform to commence but also in ensuring that the purpose of the activity remains clear and fresh in the public mind. Documenting the ultimate net benefits of reform and ensuring that they are broadly recognised and understood is essential to put the questioning of the case for reform that will inevitably come from those who have been disadvantaged by it into a proper context. The first activity is properly the responsibility of political leaders, although policy analysts can assist by providing supporting material, but the second is a responsibility that can be more widely shared. The Commission has contributed through its reviews and 'stocktakes'.

The threshold test of reform

Before the issues that are the principal concern of this paper become relevant, a proposed reform must pass a threshold test. That is, leaving aside all the complications to be discussed below, does the reform provide ultimate gains that outweigh the ultimate losses.¹ It might be argued that a proposal does not qualify as a potential reform unless it passes this test. It is worth noting, however, that in at least two recent public debates about the merits of a proposed reform, the motor vehicle tariff and the GST, substantially different answers have been given to this question by respected analysts. Analysis of proposals inevitably relies upon judgements about the most appropriate way to conduct a quantitative analysis. Judgements, and hence results, may legitimately differ. When such differences surface in the politically charged atmosphere of public debate they may well contribute to community confusion and concern. The emergence of such differences is at the core of the process by which the quality of analytical tools is improved and suppressing them is clearly not desirable.

¹ The ultimate gains and losses are those manifest in the situation that obtains after any transition phase of adjustment to the new settings of policy is complete. The complications left aside here will typically imply that a more complex test should be passed before a reform is implemented, eg the public benefit test under National Competition Policy.

Action of two kinds could, however, reduce confusion and concern. The first would aim to increase public confidence, including the confidence of those determining policy, that the differences in results are indeed caused by legitimate differences in judgements about how to model the proposal rather than by attempts to provide support for the positions of different interest groups. The increasing use being made of these types of analyses by interest groups in the public debate makes this more important. The second would aim to generate more publicly available information about why these differences exist and how they should be handled in determining policy.² Isolated attempts have been made to take such action through seminars and conferences, but such activity needs to be systematic and continuing to be effective. Substantial and interesting as these issues are, they are not the ones this paper was commissioned to address. In moving to look at those, it will be assumed that the proposed reform satisfies the threshold test.

4.1.2 An organising framework

Elements of reform

Economic reform delivers its benefits by improving the efficiency with which the economy operates.³ This is generally achieved by a reallocation of resources driven by changes in relative prices and returns.⁴ The process of reallocating resources typically takes time and involves costs; there are frictions in the economic system.⁵ These costs generally impact more heavily on some sections of the community than others. When the transition phase is complete, the ultimate changes in relative prices and returns that will have occurred generate gains for some and losses for others. Generally speaking communities care about other things, such as equity, as well as efficiency. In Australia we have elaborate tax and social welfare systems which testify to this. Given that the redistribution of income itself costs resources, pursuit of equity objectives involves communities accepting inefficient outcomes.⁶

² The Senate committee examining the GST attempted to do this by bringing the two principal modellers together to review each other's evidence.

³ As noted below, a reform could deliver benefits by improving distributional trade-off opportunities.

⁴ Economic reform comes in a variety of flavours, some of which seek to use other mechanisms to secure efficiency gains. This is discussed in section 4.4.

⁵ The notion that reform should involve a transition between the pre- and post-reform states of the world is both obvious and slippery. The pre-reform world is not static and the reform may yield dynamic gains. How long does it take to shift from one growth path to another?

⁶ Inefficient in the sense that an alternative is available that offers greater output of a least one good or service while leaving levels of other outputs unchanged, but at the cost of imposing a different, less preferred, income distribution.

In Australia we would expect the community to reject a ‘reform’ that involved extensive dismantling of the tax and social welfare systems even though it would result in a demonstrably more efficient allocation of resources. Before they can be put in place, reforms must gain community acceptance. The political process involved may give the reform characteristics it would not otherwise have. For example, a particular group in the community may have the power to block a reform and may seek to use this power to secure a redistribution as the price of allowing the reform to proceed, a redistribution that the community would not otherwise be disposed to make.

Issues in reform

This enumeration of elements suggests that the issues arising from reform may be classified into four broad groups:

- issues arising from the need to muster political support for reform
 - eg possible payment of a bribe or ‘special compensation’;
- treatment of ultimate gainers and losers
 - gains and losses that accrue when the adjustment phase is complete;
- recognising that attributes of the economic outcome other than the efficiency with which it allocates resources are important to the community
 - the distribution of income is perhaps most important, but other aspects such as the situation of particular groups, like the elderly or primary producers, may also be of particular concern;⁷ and
- dealing with the frictions arising in the transition phase
 - also called the adjustment phase, although the term adjustment is often used more broadly.

Basic questions

The issues listed above impinge on the two key reform questions:

- how should proposed reforms be evaluated?
- how should reform policies be designed?

⁷ Reflection can rapidly generate a long list of such attributes. People care about the kinds of jobs they do, which may also have implications for their health, and the kind of community in which they live, exemplified by current discussion about promoting a ‘civil society’.

These questions are closely intertwined. The broad answer to the second question is that policy design should maximise the value of the proposed reform against the criteria chosen for evaluation. Policy design sets the task for evaluation; design complexity may make evaluation more difficult. In practice evaluation and design may become an iterative process, with designs refined following evaluation in the light of insights that the evaluation process may have provided.⁸

In a democracy, the answer to the first question must be that reforms should be evaluated in a way that reflects the preferences of the community in respect of the alternative outcomes. This is a tall order. Information about the community's preferences amongst alternative outcomes is, at best, sparse. The process of public debate, particularly on substantial reform proposals, may, in part, be a mechanism to allow the community to establish preferences over relevant outcomes.

Evaluation will typically involve two kinds of activity: establishing the impact of the proposed policy change on the outcome and assessing the social value of the change. The first activity requires largely technical skills, a good understanding of the way the economy operates and of how outcomes are affected by changed circumstances. The second is ultimately something that only the community can do. Policy analysts may be able, in part, to anticipate community responses based, for example, on past responses to similar situations. They may also be able to assist the community to make a well-informed decision. How evaluation of reforms might proceed in these difficult circumstances and what kinds of policy designs might be employed form the subjects of the rest of this paper.

4.2 Policy induced and market based changes

The first question posed in the brief for this paper was: should governments respond to policy induced changes and market based changes that give rise to adjustment costs and distributional effects in different ways? A clear understanding of community responses that may be uniquely triggered by reform activity is fundamental to dealing with the issues discussed in this paper.

Some redistributive mechanisms built in

Most developed economies have built in redistributive mechanisms of various kinds. All have tax and social welfare systems of various kinds and degrees of complexity. Australia has reasonably sophisticated systems of both kinds. This

⁸ Some of this iteration may be informal and closely integrated into the policy design process. Policy design should always have in mind the criteria by which that design will be judged.

means that the response of an economy to a change in circumstances, whether policy induced or brought about by factors beyond the control of any of the participants in the economy, will be modified by the action of these mechanisms. The action of these systems depends on the characteristics of an individual, not their identity. Thus when a change in circumstances would advantage some and disadvantage others, its effects are mitigated to some degree by the action of these mechanisms. For example, if an individual gains they will pay more tax, perhaps at a higher marginal rate; if they lose their job they will be caught by the social welfare safety net. The community relies on these mechanisms to deal with day to day perturbations in the circumstances of the economy.

Special measures taken for exceptional changes

In respect of external factors, there are some mechanisms in place to deal with less usual circumstances, such as drought and disaster relief. Even more unusual circumstances, Cyclone Tracy or the Newcastle earthquake, elicit special, unique responses. For the most part these special responses are restricted to coping with natural disasters. Other changes in circumstances, such as movements in the exchange rate or changes in supply-demand balances on world markets, do not usually elicit responses beyond those already provided through pre-existing redistributive mechanisms.⁹ Thus special assistance seems to be restricted to circumstances that are unusual in respect of scale and likelihood of occurrence. By and large and within the framework of the regular redistributive mechanisms, people are expected to look after themselves.

Does reform justify special measures?

The question is do reforms introduce any new element or ought they to be treated according to the same principles. The key differentiating characteristic of reforms is that the community chooses to impose them on itself. To the extent that it therefore assumes some responsibility for the outcomes, it may be disposed to treat those affected in a way different from that which would have been selected had the change in circumstances been generated by external factors.¹⁰ There are clearly

⁹ At various times there have been special assistance schemes for rural producers experiencing adverse market conditions. These have often been linked to other contemporaneous political factors, as has been seen in the recent treatment of pig producers. Generally the tendency has been to encourage such producers to protect themselves against such contingencies, with 'assistance' restricted to recognition of their special circumstances through measures like income averaging in the tax system.

¹⁰ Treating the community as a 'super-individual', including through the use of a social welfare function with similar properties to an individual preference function, is subject to a range of well-

circumstances that make it more likely that the community would assume this responsibility. Examples would include the impact being large and difficult to anticipate, the affected group being poorly placed to deal with the consequences within their own resources, and the consequences being clearly and closely associated with the reform. Even if the community does not assume responsibility for reform in this way, the distributional consequences, after allowing for the operation of the pre-existing redistributive mechanisms, can be such as to affront the community's usual notions of equity. In such circumstances supplementary measures may be put in place, which may involve one-off payments or adjustment to the parameters of existing redistributive mechanisms. Here the handling of a reform by the community is no different from its handling of an external shock that produced the same initial outcome.

Is the social welfare function altered by the presence of reform?

The usual approach in economic theory would be to assume that the social valuation of a particular economic outcome is independent of the path by which it is reached or the circumstances that brought it about. The discussion above suggests that there are plausible grounds for believing that the community may wish to react differently to an outcome that is the product of reform than to one that is the product of a change in external circumstances. Formally, this amounts to asserting that the social welfare function may depend upon the path by which an outcome is reached, in particular, whether or not it involves reform, that is, that the social welfare function exhibits a form of hysteresis.¹¹ If the presence of reform causes some change in the social welfare function, it will be important to distinguish its effects from those associated with the usual notions of equity, namely those that apply in the absence of reform. Thus, following a reform, the economy assumes a new configuration that is jointly the product of the changes embodied in the reform and the pre-existing set of redistributive mechanisms. Ignoring the fact of reform the community may decide a better outcome can be obtained by some further redistributive measures. It seems appropriate to make judgements about changes of this kind using the same criteria and principles that would be applied to other social welfare issues. In the rest of this paper such measures will be described as equity-driven special compensation.¹² Beyond these measures, the community may decide that, because

documented difficulties. These are ignored here to allow a focus on other issues which are likely to be more serious as far as the topics of this paper are concerned.

¹¹ The social welfare function may, in fact, depend on the type of reform, not just the presence or absence of reform.

¹² It might be thought that this is an inappropriate use of the adjective 'special', since this form of compensation will be provided however the outcome is reached. While accepting the logic of this argument, this paper follows the definition in the workshop brief which states that special

reform is involved, some special compensation is required. To distinguish them, such measures will be termed reform-driven special compensation.¹³ Some of the issues raised by the possibility that reform designs may need to include measures of this kind are discussed below, including the possibility that a single policy measure may serve a variety of purposes.

4.3 Evaluation and policy design

4.3.1 Evaluation

Political support

Simple analytics

A reform needs to secure political support in order to be implemented. Where a group enjoys the power to block implementation, they may demand some favourable treatment as the price of allowing the reform to proceed. Paying that price may or may not affect the community's valuation of the reform. This is illustrated in figure 4.1. Here the economy is composed of two individuals, A and B. The initial situation is one where the community has adopted redistributive policies that maximise the social welfare function given the constraint of total available income.¹⁴ A reform is proposed which would initially both make more total income available and substantially alter the distribution of income. Suppose decisions are by consensus and B demands that they should be no worse off after the reform. It may be that the nature of the community's social welfare function, including any reform driven component as defined in the last section, would have delivered that to B anyway. This is the situation represented by SWF1 in figure 4.1. Alternatively, the community may have preferred to leave B rather less income, the situation represented by SWF2. Here the reform delivers less community benefit than it would have if B's consent had not been required. As drawn the community would still gain by proceeding with the reform, but if B's demands had been more extreme a position might be reached where the community prefers not to proceed with the reform. An evaluation needs to take account of any politically driven

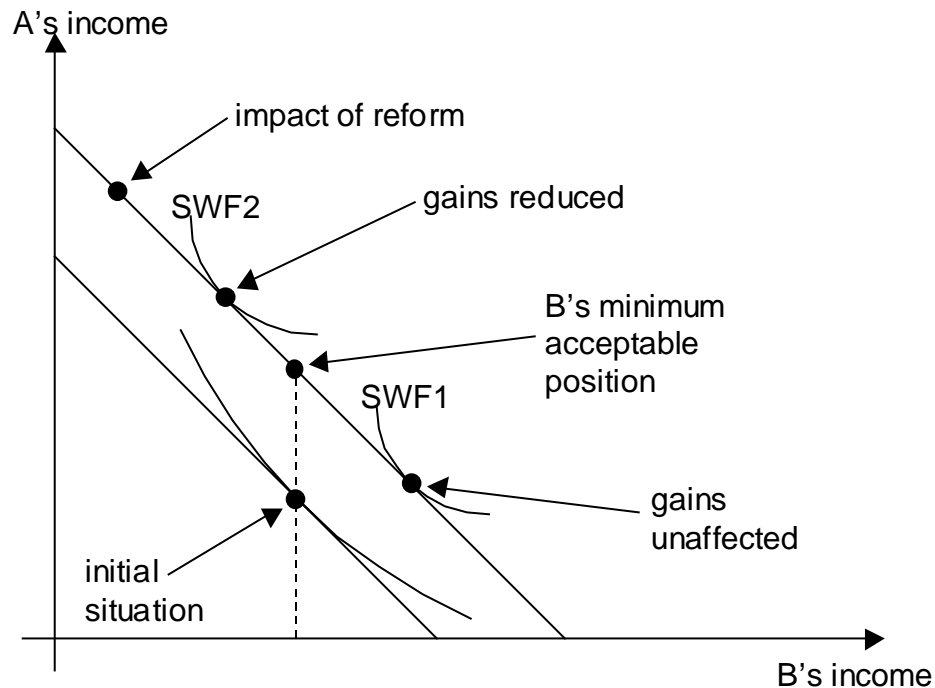
compensation is that made available 'over and above that available through the general social security system', by implication the system in place before the reform is instituted.

¹³ There is a third species of special compensation, politically driven, that will be encountered below.

¹⁴ Here the deadweight losses that may be associated with practical redistributions are ignored. Some of the substantial complications that these introduce are discussed below.

special compensation and any reduction in the gains to the community that may be associated with it.¹⁵

Figure 4.1 **Impact of distributional constraints**



Alternatives to special compensation

In Australia it is rare that a group has absolute political power to block a reform. The more common situation is that a group has secured a degree of sympathy for its position from a larger section of the community that is unwilling to allow the reform to proceed without the consent of the group. Here an alternative to meeting the demands of the group is to change the views of the relevant section of the community. The long history of debate about tariff reform in Australia might be seen to contain elements of this kind. Persuasion takes time and has an uncertain outcome. Weighing these alternatives in a reform evaluation to determine whether politically driven special compensation should be paid will be difficult.

There are further complicating factors. A decision to pay special compensation in one case may encourage other groups to build a similar position and extract compensation for some other reform. Independent of the distribution implications,

¹⁵ In any actual situation, there may be clues about whether the community would have been disposed to meet their conditions anyway in the stridency of demands made by groups and the degree of acrimony in the decision process.

the community may regard such payments as objectionable on moral grounds. If the effect of the group's demands is to make the reform outcome less attractive than the current situation, then there may be no alternative to a strategy of attempting to change community views. In circumstances where this kind of political power is being exercised there may be little the policy analyst can contribute beyond identifying the size of the potential overall gain and highlighting the alternative ways in which it might be used. Presentation of information about consumption tax and production subsidy equivalents of tariffs could be seen as an attempt to do this.

Ultimate gainers and losers

Importance to the community should not be underestimated

In a generally competitive economy, the ultimate benefits of many reforms may be widely spread through the community and after the adjustment phase is complete the losses may be modest. Given the degree of community concern about the balance and incidence of gains and losses, it is nevertheless important that evaluation pay attention to these issues. In many cases, preliminary work may establish that the extent of change does not justify further work — that is, the changes lie within the bounds of the day to day perturbations of economic circumstances that would be satisfactorily handled by existing redistributive mechanisms. But this needs to be clearly established not presumed. Where the effects are substantial, identification of their incidence and scale is likely to be an important first step in an iterative process of refining policy design. There are a variety of modelling techniques available for this kind of work and they are constantly being refined. Developments that increase public confidence in the accuracy of the analysis are obviously of particular value. Experience with similar reforms may also yield useful insights.

Some gains and losses are hard to capture

Some benefits are by their very nature widespread. They do not accrue to the owners of particular resources or skills, but rather to the economy as a whole. Reference is often made to dynamic gains. These are gains that accrue in the way the economy grows and develops. These may come, for example, through the changed environment brought about by reform enhancing the entrepreneurial spirit in the economy. An instance of this is recognised when reference is made to the economy becoming more outward looking. Reforms that improve the functioning of the price system, giving a more efficient allocation of resources, may also improve the flexibility of the economy, allowing it to deal more quickly and effectively with external shocks. Some reforms can alter fundamental aspects of the way the

economy functions, for example, reforms in industrial relations, the finance sector and to government business enterprises. The benefits of such reforms are difficult to identify and evaluate, typically taking some time to become evident. The difficulties in first clearly identifying and then establishing the reasons for the increase in productivity growth that seems recently to have occurred in Australia illustrate some of the problems. One way of responding is to attempt to identify a generic class of reforms as very likely to produce such gains. It can be difficult to sustain community support for such a reform strategy as the current criticisms of national competition policy reforms indicate. Such fundamental reforms can also involve losses that are difficult to anticipate. Increasing the competitiveness of the environment in which an organisation operates will generally cause it to re-evaluate the range of activities it undertakes. This process may result in the reduced provision of some services that the community values. Although policy measures, as discussed below, can offset such effects, they generally involve some costs being borne by the community.

Equity and other considerations

Redistribution cost resources

The case has already been made that the evaluation of reform needs to take account of factors other than efficiency. Some of the issues this raises have already been discussed and its impact on policy design is dealt with below. Confronted by these difficulties, comfort is sometimes sought in the proposition that the problem of efficiently allocating resources can be separated from that of equitably distributing them. The proposition states that, if a reform increases efficiency, there must be a redistribution of the resulting gains that gives a Paretian improvement in community welfare. This proposition holds only when redistributions may be effected costlessly. At the scale of redistribution currently undertaken in Australia, this is manifestly not the case. Whether the agencies distributing income supplements are publicly or privately owned, their operations still consume resources.¹⁶ The deadweight losses associated with tax collections are well known.¹⁷

¹⁶ The assumption implicit here and elsewhere is that there is alternative employment for these resources that would increase the total income of the community. If there is persistent involuntary unemployment, this assumption may not be justified.

¹⁷ Tax revenues are used both to effect income redistributions and to support government expenditure on goods and services. Since taxes are not hypothecated to one or other task, it is not possible to identify the deadweight loss associated with the taxation element in an income redistribution unambiguously. However, the lower bound, represented by the deadweight loss of the least distorting group of revenues capable of supporting the current level of transfer payments, would be significant. If a reform package demanded greater revenues to fund its redistributive elements then it is the deadweight losses associated with the new taxes that are

Deadweight losses complicate reform evaluation

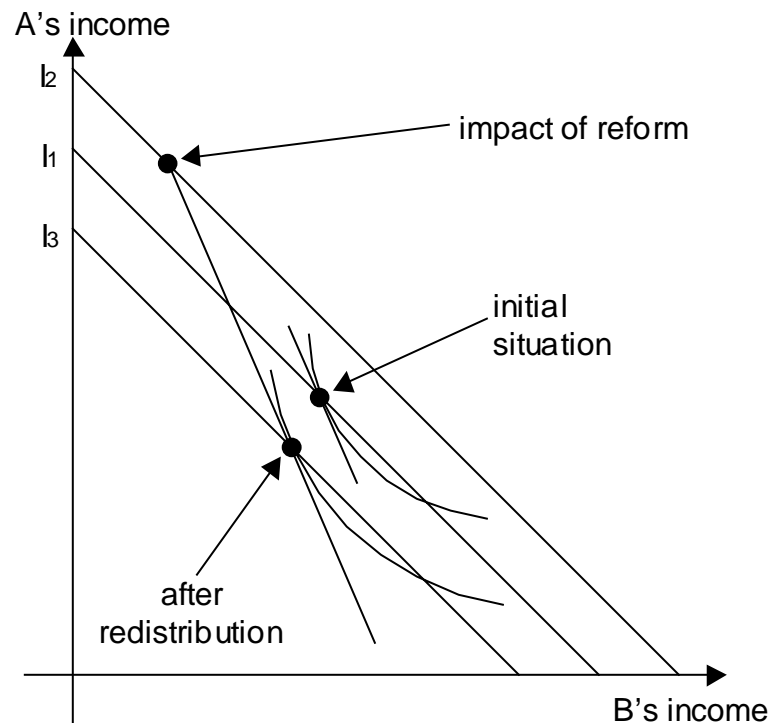
The impact of these deadweight losses on the value to the community of a reform can be considerable. Figure 4.2 illustrates the general problem. Here we have an economy similar to that depicted in figure 4.1, except that now redistribution costs resources, a dollar taken from A may only yield a 90 cent gain to B.¹⁸ The initial situation is one in which some redistribution to B has been made and, given the marginal cost of redistribution, it is the best outcome the community can obtain. The initial impact of the reform illustrated is to increase aggregate income, but redistribute it towards A. The scale of this redistribution combined with the cost of subsequent corrective action is such as to leave the community worse off than before the reform.¹⁹ Aggregate income measured immediately after the reforms, I_2 , being greater than in the initial situation, I_1 , would provide a misleading indicator of the impact of reform on community welfare. Aggregate income after redistribution, I_3 , correctly indicates a welfare loss. Ignoring the cost of the redistributions a community may wish to effect following a reform could give an inflated estimate of the value of the reform. This effect will be more marked the higher are the deadweight losses associated with income redistribution and the greater is the distributive impact of the reform. The difficulties of designing practicable policies to undo the distributive effects of a reform can be considerable. Even when it is possible to identify those who have been disadvantaged by reform, it can still be hard to design policies that direct compensation to them without also supplementing the incomes of others that have not been so disadvantaged. The problems are illustrated by recent experience with tax policy in Australia that has highlighted the difficulties of designing a redistribution policy that would leave no one in the community worse off after the imposition of a GST when the rate is much above 10 per cent.

relevant. These are likely to be higher than the average deadweight loss per dollar raised of existing taxes.

¹⁸ Simply for convenience, the figure assumes that the per dollar cost of a redistribution is independent of its scale. In practice the cost is likely to increase with scale.

¹⁹ The converse of this is that a reform can provide value for the community by moving the economy to a preferred income distribution even though it may not increase aggregate income, indeed may even reduce it. Social welfare reforms operate chiefly in this sphere.

Figure 4.2 **Interaction of reform and income redistribution**



What can evaluation achieve?

Reform evaluation needs to take careful account of distributional consequences. A minimum objective would be to establish whether the reform has significant distributional consequences, after taking account of the effects of the operation of the established redistributive mechanisms. If the community has indicated, either in the current context or through its reactions to early reforms, how it would wish to respond, evaluation can proceed to cost the required redistribution. Again the process involved may be an iterative one, with evaluation identifying policy design shortcomings and, perhaps, suggesting ways they might be addressed. The iterative loop may encompass not only policy evaluation and policy design, but also the definition of community preferences. As the understanding of the consequences of a reform in the community increases, the reform driven component of the desired redistribution may evolve. When finally evaluating reforms for possible implementation, that is, when comparing them to the current situation, the comparison must involve the ultimate outcome, allowing for all the redistributive supplements to the basic reform.

The transition phase

Adjustment costs defined

At its broadest, the process of reform involves changing values and perceptions as well as changing power relationships within the political process. The notion of adjustment costs is variously used to encompass different elements in that broad process. Here it will be used in a narrower sense to refer to the costs of making the transition from the situation before a reform is imposed to the state applying after the economy has fully accommodated the reform.²⁰ On this basis, adjustment costs are the sum of costs borne during the transition, net of any amelioration provided by adjustment assistance and the cost to the community of providing any such assistance. As discussed below, one of the objectives of the design of adjustment assistance will be to minimise this sum. Some adjustment costs can be difficult to identify. For example, a reform may involve a temporary increase in the unemployment rate. The resources to provide the temporarily higher level of social welfare payments required will necessitate the postponement of other expenditure or temporarily higher taxes. Both of which impose costs on others that flow from the introduction of the reform.

Sensitive to discount rate

Adjustment costs, by their very nature, are finite in duration. In this way they differ from the benefits of reform which are typically a flow of extra income, say, extending into the indefinite future. A present value calculation is necessary to compare the adjustment costs of reform with the stream of benefits. Such a calculation will be sensitive to the discount rate chosen. If a reform produces a stream of benefits, no matter how small, it can be justified in the face of any finite adjustment costs by choice of a suitably small discount factor. Considerations of inter-generational equity might suggest choosing a factor rather smaller than an individual rate of time preference. Taken to its limit, such an argument could produce an outcome equivalent to that obtained by setting the discount rate to zero, that is that adjustment costs can be ignored for reforms producing any positive stream of benefits. Although an attractive simplification of the problem of policy design, commonsense and the practical realities of community decision-making suggest that this argument should be set aside. Nevertheless, choice of discount rate may exert a strong influence over the outcome of a policy evaluation and sensitivity analysis may have a useful role.

²⁰ The potentially slippery nature of this concept has already been commented on. For the purposes of this discussion, it will be assumed that a pre- and final post-reform state can be reasonably clearly identified.

Allowing for adjustment costs in evaluation

Fundamentally, evaluation should deal with the reform as it is proposed to be implemented. If a reform is part of a package then the whole package should be evaluated because there may be important interaction effects. If a reform involves adjustment costs, and possibly policies to ameliorate them or redistribute their burden, the value of the overall package needs to be estimated. In practice it may be difficult to identify, let alone estimate, all the adjustment costs flowing from a reform before it is implemented. Previous experience of the impact of reforms is likely to be a major source of information so it is important that such information be collected as systematically as possible. It is hard to model formally the frictions in the adjustment mechanisms that generate adjustment costs. Comparative static modelling can, however, generate estimates of some of the parameters of change, which can be combined with other information to indicate orders of magnitude at least. For example, in the labour market, estimates of the number of workers displaced as the result of contraction in some sectors and the number of new hires as a result of expansions elsewhere as well as with associated retraining and regional migration requirements should be available. These could be combined with previous experience of the economy's response to such situations to give some estimates of likely costs of adjustment. Other potential sources of information include experience of reform in similar countries, assessments by affected groups and longitudinal data, for example, on the duration of unemployment. An important parameter of the transition is its duration, not least because this determines the date from which the full benefits of the reform begin to flow.

Case by case expensive but the alternative is dangerous

Case by case evaluation of reforms is expensive and it is natural to look for broad principles that can provide cheaper answers. For example, it might be argued that reforms with clear efficiency benefits should be allowed to proceed with the fallout being dealt with as it manifests or that existing social welfare and other support programs are extensive and can be relied upon to provide sufficient adjustment assistance. Such principles are dangerous for two reasons. First, they may lead to the wrong conclusion. The fact that a reform produces large efficiency gains reveals nothing about the size of adjustment costs associated with it or its impact on income distribution and other issues of concern to the community. The capacity of existing social welfare and other support programs to deal with the consequences of a reform depends very much on the nature of that reform and, in any event, the extra burden on those programs imposed by the reform should be counted in any evaluation.

Second, broad principles in evaluation lend themselves to misrepresentation in public debate. It is often easy to dream up an example in which the general principle

fails, undermining public confidence in the evaluation process. It seems to be a facet of human nature that everyone believes their own situation to be unique and that, therefore, broad principles cannot be appropriately applied to it. To maintain their value, evaluation processes must, like Caesar's wife, be beyond reproach.

4.3.2 Policy design

Political support

Policy design in a political context

Mustering the political support necessary to implement a reform may be a complex process stretching over many years, involving changes in the community's attitudes to various issues and the waxing and waning of the political power of certain groups. Many of these considerations are well beyond the scope of this paper. There are, however, some aspects of policy design careful attention to which may make the task of building the necessary political support easier. Paying careful attention to the full range of community concerns about reform in policy design and evaluation will increase the likelihood that the community will accept the conclusions of the analysis. A program of reform that spreads the benefits and costs across the community and is clearly related to sought-after objectives is both more difficult for a particular interest group to oppose and less likely to impact very adversely on any particular group. Tying such a program to changed external circumstances can often galvanise support for reforms that might not otherwise command it. The shortcomings in Australian economic performance were evident at the beginning of the 1980s to anyone who cared to look, but it took the current account crises of the middle of the decade to galvanise public support for a reform program. Such a program can also provide a clearer sense of the overall direction of policy, increasing public confidence that the outcomes will be positive. The converse is that failure of such a program to deliver demonstrable benefits can undercut community confidence in reform generally. Design of such programs, therefore, demands great care.

Guidelines for politically driven special compensation

If it has been determined that politically driven special compensation may be desirable, the issue becomes the method of delivery. It should achieve its primary objective of removing the political blockage to the implementation of reform. The mechanism to effect the reform needs to deny the blocking group any further opportunities to make demands. Desirably, the compensation should be made available in a way, perhaps by attaching conditions such as the achievement of

certain benchmarks, that gives the blocking group an interest in seeing the reform proceed. The waterfront reforms of the late-1980s would rate poorly against these criteria. The waterfront unions had every incentive to seek improved terms at each step of the process and little or no incentive to support it. The employers' costs of adjustment were substantially subsidised without any guarantee that performance would improve and benefits be delivered to the users of port services. In addition, demanding something in return for such special compensation, through conditionality, may make its payment more acceptable to the community by making it look less like a blatant bribe.

Ultimate gainers and losers

As pointed out above, the pattern of final gains and losses imposed by a reform will be mitigated by pre-existing redistribution mechanisms. Using the terminology introduced there, community desire for further adjustments to this distribution may be either equity or reform driven. Where feasible, packaging reforms that have differing incidences of gains and losses reduces the likelihood that either kind of special compensation will be required.

Equity driven special compensation mechanisms well established

Where the community determines that there is a case for equity driven special compensation, it should presumably be handled in a way consistent with the approach already in place for dealing with equity issues. Generally in Australia, transfers made to redistribute income take the form of straightforward cash payments, usually means tested. Some payments, for example, to the unemployed, are subject to additional conditionality (eg a job search test). Payments of this kind have a dual purpose: transferring income to the individual as long as they remain in a relative disadvantaged situation and assisting them to move out of that situation. In this respect, they have some characteristics of adjustment assistance, a point taken up below.

Although subject to continuing refinement, the social welfare system in Australia is reasonably stable and broadly supported in the community.²¹ Consistency with existing practice can be most readily achieved by using existing compensation mechanisms to deliver any equity driven compensation considered necessary. This may require some adjustment to the parameters of those mechanisms, including in the definition of those entitled to receive them. For many reforms, such an approach

²¹ This is not to suggest that there are not differences of view within the community about which groups should be assisted and to what extent, but that few individuals and no major political parties advocate wholesale dismantling of the system.

may be capable of providing all the equity driven special compensation required. It has the obvious advantage of not requiring any new apparatus. Some kinds of losses are not, however, covered. As the recent debate over GST compensation has highlighted, some individuals pay little income tax and receive few social welfare benefits. Similarly, losses that manifested in a fall in the value of the family home would also lie outside these systems. Where minor modifications to existing mechanisms cannot achieve the outcome sought, it is clearly highly desirable that any new measures be introduced within the broad framework and philosophy of the existing system and draw on experience of operating that system. The same line of argument suggests that equity driven special compensation measures be assessed using the criteria and methodologies already developed for the analysis of social welfare policy.

Reform driven special compensation guidelines

Reform driven special compensation, by its nature, lies outside the general framework of equity driven compensation mechanisms. As such it poses particular problems. A major issue is the precedent that may be established by compensation of this kind. Groups disadvantaged by reform may seek to use the fact that those disadvantaged by earlier reforms received compensation to buttress their own case for receiving it. This danger can be reduced by specifying principles that will identify the conditions under which and the form in which such compensation will be made available.

One approach is to try to identify the aspects of disadvantage that seem to provoke the community to feel a need for reform driven special compensation. As discussed above, these might include: that the disadvantage demonstrably flows directly from the reform; that the effect on the disadvantaged group be significant; and that the group be poorly placed to anticipate or respond to the reform. The precedent offered by unemployment benefits suggest that such compensation might be paid in a form or subject to a conditionality that encourages individuals to move out of the disadvantaged group. Consider, for example, a reform that reduces the market value of an individual's skills. The individual could be paid a lump sum in compensation. Alternatively, consideration could be given to providing a subsidy for a program of skills acquisition. This offers potential gains to the community from the increased earning capacity of the individual and increases the likelihood that the individual will see themselves as having dealt successfully with the challenge of change rather than as a victim of reform. On occasion, relocation assistance may be capable of delivering similar benefits. Working within a framework of broad principles also provides a basis for developing criteria for the assessment of measures.

Often little merit in attempting to tax gainers

Just as the existing redistribution mechanisms automatically provide some relief to those disadvantaged by reform, they automatically levy some taxes on those advantaged. Going beyond this may be both practically difficult, for example, because gainers are difficult to identify, and may be seen as an inappropriate expropriation of private property.²² Often gainers have previously been unfairly disadvantaged, for example, the implicit tax on exporters levied by tariffs. In a competitive economy, gains may be short-lived and benefits rapidly distributed across the community. Indeed, many reforms aim to create conditions that will ensure this occurs. The case for seeking to tax gainers would perhaps be strongest where large windfall gains occur.

Equity and other considerations

Trade-offs will be made

Governments do trade off efficiency against equity and other objectives. Governments are elected on platforms that include promises to make such trade-offs and are re-elected when they have made them. In this sense, trade-offs are made because the community requires them to be.²³ The ultimate decision-making process here is the ballot box, but it is a relatively crude process for dealing with complex issues and liable to be misled. Equity and other considerations may also be important in the transition phase, for example, in the distribution of the burden of adjustment costs.

Aspects of policy design

Appropriate policy analysis, design and evaluation can contribute to better outcomes from the democratic process by helping to identify the objective of the trade-off and by making clear the costs and benefits of trade-off measures (see box 4.1).

²² Clearly opinions differ on what constitutes ‘inappropriate expropriation of private property’, varying from ‘tax is theft’ to an opposition to the private ownership of the means of production. Generally, Australians treat extensions of the tax system with suspicion.

²³ It is, of course, perfectly possible that the community would elect a government that offered a platform including a particular trade-off, but vote against the implementation of that trade-off if offered an opportunity. These ‘indivisibilities’ in the political process are ignored here.

Box 4.1 Concern about the decline of regional Australia

Recently, concern has been expressed about the decline of regional Australia. The populations of small country towns are declining and it is becoming uneconomic to supply them locally with many of the services that they have been used to receiving. This kind of change is not a new phenomenon and is often driven by fundamental change in technology, for example, the replacement of horse drawn transport by trains and trucks able to travel much further between stops.

Some have argued that policy measures are necessary to arrest this decline. The first question to be addressed in policy analysis is why? Does the community want to preserve certain lifestyles or a kind of rural museum? Are there strategic or other community gains from having some occupation of regional areas? Is market failure of some kind suspected?

Proper identification of the objective begins to suggest the kind of policy design required to achieve it. In the case of the first two objectives, there would seem to be a case for the community to share some of the costs of remote living. For the last objective, further investigation of the cause of any market failure should precede the formulation of measures to address it. For example, it may be felt that there is insufficient competition in the provision of transaction services. This may in turn be traced to barriers to participation in clearing house arrangements or privileged access for a few institutions to lender of last resort facilities at the Reserve Bank. In such circumstances, appropriate policy responses are fairly clear and, interestingly, may involve more reform not less.

The process of clearly identifying the objective, which may include public debate about the issue, may have the important side benefit of improving community understanding of the ‘problem’. If, for example, it becomes accepted that the development causing concern is part of a wider process of evolutionary change within the economy and society, concern may be reduced or refocussed on assisting those affected to adjust. If the appropriate policy measure involves a subsidy element, the resources to provide that subsidy should come from general revenue and not be provided through a mechanism like an unfunded community service obligation or a tax expenditure. These kinds of resource provision are generally more distortionary, increasing the deadweight loss. In addition, they hide the cost of the subsidy, indeed may make it impossible to estimate it accurately, thereby frustrating informed community decision making about the quantum of resources that should be devoted to achieving the objective in question. An excellent principle is that, when it is suggested that policy measures be introduced to deal with an

issue, the issue and alternative measures to deal with it should be subjected to a public process of analysis and review before any decision is taken.²⁴

Mapping the community's social welfare function

Policy evaluation, and hence design, cannot avoid judgements about the nature of the community's social welfare function, that is, how the community values alternative outcomes. An important guide to the shape of this function is the community's reaction to and treatment of similar situations in the past. Other potential sources of information include safety net mechanisms and their associated eligibility criteria, principles underpinning emergency relief arrangements and the specification of the circumstances in which it may be triggered, the design of the tax system, legislation (for example, public benefit tests in the *Trade Practices Act* and the general policy guidelines in the *Productivity Commission Act*) and terms of reference for inquiries. Great care is required to avoid going beyond the guidance these indicators may provide and, in particular, any suggestion that the analyst is allowing his own views to colour the analysis offered. Formal methods for describing the social welfare function are also available, for example, through the use of distributive weights. Although perhaps useful for indicating the range of alternative community valuations of a given set of outcomes, such methods can be sensitive to the choice of weights, which is often a contentious matter, and difficult to explain convincingly in simple terms. Exclusive reliance on such formal methods is likely to restrict access to the analysis and, thereby, the influence of it.

Simple rules not helpful

It is difficult to justify simple rules such as weighting losers interests more highly than winners, for losers may be rich or poor as may winners and the significance of the loss or gain proportionately small or great. Conservatism in policy evaluation, that is rejecting reforms unless the potential efficiency gains far outweigh any adverse social or distributional consequences, may well lead to the rejection of worthwhile reforms. Such conservatism might be justified if the magnitude of gains were much more uncertain than the magnitude of losses. Typically, costs are easier to identify and quantify than benefits, for example, dynamic gains. This builds into policy evaluation a natural degree of conservatism. A better response to community concerns about the cost-benefit ratio of reform would be to give more serious attention to the adjustment, social and distributional aspects in policy design and evaluation. Overall, the major way for the policy analyst to add value to community

²⁴ The recent Productivity Commission inquiry into the provision of assistance to the pigmeat industry shows how such a process can operate, see PC (1998a).

decision making is by identifying and communicating the available trade-offs clearly and graphically.

The transition phase

The objectives are familiar

The objectives of policy in the transition phase can be classified using the same scheme adopted for policy measures directed at the ultimate consequences of reform. The primary division is into the objectives of improving efficiency and meeting community concerns about equity and other considerations. Using the terminology introduced above, community concerns can be subdivided into those that are equity driven and those that are reform driven. A given measure, for example, phasing, can be aimed at a mix of objectives, for example, improving efficiency by reducing the magnitude of the shock to the economy and addressing equity concerns by reducing the burden of adjustment on affected groups.

Improving efficiency

Transition measures to improve efficiency aim to minimise the sum of adjustment costs, the cost of the measures employed and the costs of foregoing the full benefits of reform during the transition phase, calculated as a net present value over the transition phase. Efficiency enhancing measures may operate in several ways. If the costs of adjustment rise at an increasing rate with the magnitude of adjustment required, breaking the adjustment into steps by phasing in the policy change can reduce adjustment costs. Pre-announcement aims to reduce adjustment costs by allowing adjustment to take place before policy change is introduced. Both, however, postpone the date at which the full benefits of reform become available — pre-announcement rather more markedly than gradual introduction. Policy aims to balance, at the margin, the gain against the loss.

Facilitative measures, in contrast, aim to speed up the process of adjustment by expending community resources on measures designed to hasten the process of resource re-allocation. Examples include retraining and relocation assistance. Here the aim of policy design is to balance, at the margin, the gain from bringing forward the accrual of the full benefits of reform against the cost of the programs required to achieve it.

Appropriate ordering or combining of reforms can also enhance efficiency. It used to be fashionable to criticise the progress of reform in Australia for exactly reversing the optimal order, identified as factor market reform followed by product

market reform followed by capital market liberalisation.²⁵ The costs of adjusting to one reform can be reduced by the simultaneous introduction of a complementary reform. For example, the costs of adjusting to increased competition in product markets can be reduced by reforms that improve efficiency in the provision of factor services. Thus companies subject to tariff reductions on their products often complained that their task was made more difficult and the community gains from tariff reform reduced by continuing inefficiencies in transport, energy supply and the labour market. In the limit, the adjustment costs of some reforms may be prohibitive unless embedded in an appropriately structured package. It might be argued that the wage restraint achieved by the Accord was only possible because of the social welfare reforms with which it was packaged.²⁶

Addressing equity and other concerns

Many of the points made above with regard to special compensation for the ultimate effects of reform apply also to the transitory ones, with the important qualifier that, since the effects are temporary, the case for providing special compensation will generally be weaker. In addition, the transition offers opportunities to secure some return for the community for any special compensation by making it available in a way that facilitates adjustment and secures some efficiency gains, even though the payment could not be justified on efficiency grounds alone. Tying the special compensation to the adjustment process may also discourage rent seeking behaviour by reducing the value of the pay-off to the rent seeker. This can be done through the form of the payment, for example, grants or subsidised loans to support participation in acquiring new skills, or through conditionality, for example, of the kind applying to grants under the Best Practice Program. These mechanisms can also be used to provide those receiving special compensation with reasons to support the reform, for example, by providing them with an opportunity to permanently improve their economic prospects.

Pros and cons of phasing

Slowing the rate at which reform is introduced is one way of reducing community resistance and adjustment costs. Although natural to consider in some cases, for

²⁵ The order actually adopted owes much more to the relative ease of obtaining political support than to optimal policy design. Arguably, capital market liberalisation led the way because its implications were least clear to the community.

²⁶ It might seem strange today to consider the wage restraint of the 1980s as a reform. In its time, however, it contributed to reducing inflation, avoiding the commitment of resources to arbitrating excessive wage claims and reducing uncertainty about wage outcomes. All of these delivered efficiency gains over the pre-existing situation.

example, tariff reductions, it would be disastrous in others. For example, maintaining both a wholesale sales tax system and a GST while the rate for one was phased down and the other up would increase adjustment costs very substantially over a simple cut-over from one system to the other. Costs of this change can be reduced by pre-announcing it, but excessive delay in introducing the change can also exacerbate adjustment problems. For example, because the ultimate impact of the change is to reduce prices of some consumer durables (eg cars) delaying can depress consumption in the interim necessitating a potentially costly ramp down and up in production.²⁷ Some kinds of tax changes need to be introduced immediately to prevent avoidance.²⁸ Whatever the benefits of some kind of phasing arrangements, all involve costs by delaying the flow of ultimate benefits. The case for phasing should be considered on its merits in each instance. Because phasing is a relatively blunt policy instrument, the possibility of combining limited phasing with some form of adjustment assistance to provide the best outcome, as was done for many of the tariff reductions of the 1980s, should not be overlooked. Lastly, in designing measures of this kind, it must be remembered that delays in policy implementation can invite lobbying for further delay or abandonment of reform. Supposedly temporary interruptions to the implementation of reform, as with the recent decision on car tariffs, or long lead-time pre-announcements of change particularly invite this kind of lobbying.²⁹

Facilitation demands imagination

Economic theory provides little insight into the processes of adjustment in an economy and, therefore, little assistance in creating efficiency enhancing facilitation measures, beyond general notions like incentive compatibility. There is plenty of scope for imagination! Careful study of the process of adjustment to identify bottlenecks may identify areas where the expenditure of community resources would have the greatest impact. Experience with previous facilitation programs may

²⁷ Motor vehicle manufacturers and distributors are already expressing concern about the possible impact of the change on these grounds.

²⁸ This gives rise to the celebrated phenomenon of legislation by press release. Because there can be a long delay before the measures are finally passed by the Parliament and can differ in important respects from those announced by the responsible Minister, such a process imposes costs of its own. The recent introduction of the superannuation surcharge shows how private sector decision making can be adversely affected by this practice.

²⁹ A tariff freeze, that is a temporary interruption to a program of tariff reductions, is difficult to rationalise. If sufficient efficiency gains to outweigh the various costs were not available, no change in tariffs is the appropriate policy. If gains were available it is difficult to believe that deferring any change for a lengthy period achieves the best balance between costs and benefits. It is interesting that the two main models used to analyse the car tariff both found a freeze to be the least preferred option.

also provide guidance about the relative effectiveness of alternative measures. Given the difficulty of identifying in advance measures likely to provide effective facilitation and the importance of not wasting community resources, trial programs may play a useful role.³⁰ This allows a limit to be placed on the initial commitment of resources, with the availability of further resources being conditional on obtaining positive outcomes. If this approach is used, the assessment of the effectiveness of the program needs to be thorough and rigorous, perhaps carried out by an agency other than the sponsor or administrator of the program. Where a reform is composed of a number of elements — the reform itself and measures to address distributional and other concerns flowing from the implementation of the basic reform — it is important to adopt an integrated approach to the design of transition measures. This involves recognising that the endpoint towards which adjustment must be facilitated is the joint outcome of the various components of the reform, not the outcome that would have been obtained from just implementing the basic reform. In addition and as already noted, where special compensation is to be paid, it can be designed to facilitate adjustment.

Designing reform packages

Reference has been made to the benefits of introducing a package of reforms together. These gains come principally in two ways. First, by widely spreading costs and benefits across the community, they reduce the need for special compensation of all kinds. Second, by implementing complementary reforms, they increase the flexibility of the economy and reduce adjustment costs. Maximising the benefits from introducing a package of reforms requires that regard be had for both of these aspects of package design. Packages that concentrate the costs and benefits on particular groups and place a large, cumulative burden of adjustment on particular sectors will be counterproductive. In addition, packaging can provide access to benefits not available from a piecemeal approach. For example, a program of general tariff reductions allows the adoption of a top down approach and the simplification of tariff schedules.³¹

³⁰ Resistance to introducing facilitation in this way and an insistence on a sizeable initial commitment of resources may suggest that the measure in question is being sought as special compensation rather than on efficiency grounds.

³¹ A top down approach reduces the highest tariffs first in a levelling down fashion, thus reducing the dispersion of tariffs as well as their general level. The program of across-the-board tariff cuts introduced in 1988 took advantage of both opportunities.

4.4 The evolution of reform and its implications

Different reform processes have different characteristics. An interesting aspect of the history of economic reform in Australia over the last decade or so has been the increasing sophistication of the reform process — individual reform elements have become aggregated into more complex processes. This evolution of reform is posing new problems for the analysis, design and evaluation of reform policies.

Simple policy change reform

One way in which reform processes differ is in whether the reform is defined by a policy change, with the outcome being uncertain, or by the objective of reform, with the policy required to achieve it being uncertain. A simple policy change reform would involve some well defined change to policy settings which can be put in place relatively easily, for example a change to a tariff rate or the removal of an export control.³² Typically, government would more or less directly control the element subject to change. The new policy setting produces a new outcome, typically after a transition phase in which the agents in the economy adjust behaviour and resources are redeployed. Although the policy change is well defined, the nature of the prospective new outcome is uncertain. Evaluating the reform involves establishing the nature of that outcome and whether it is superior to the current situation. This is, as it were, the classic problem in policy analysis that calls forth the well known battery of economic models that have been seen in recent action on the car tariff and the GST. It is also the context into which much of the earlier discussion fits most readily. Largely because establishing the nature of the prospective new outcome is difficult and often contentious, little attention has typically been paid to the costs of the transition.

Objective driven reform

A quite different process results when reform is driven by the outcome objective to be attained. Although this objective may be relatively well defined, for example, to improve productivity on Australia's waterfront, it is not obvious what settings of policy would achieve it. Here, the task of policy design is substantial. To ease this task an intermediate target that is easier to link to available policy instruments is often specified, for example, reduce the number of workers on the waterfront. For

³² Here the focus is on the economics of the reform process. Thus a policy change that involved, for example, only a straightforward change to a piece of federal legislation would be regarded as easy even though building the political support necessary to allow the passage of that legislation might be difficult.

this kind of reform, policy design is the most complex task and effort tends to be concentrated there. The handling of transitional, distributional and other issues, to the extent that they are covered, tends to be combined with the task of policy design. Analysis of the impact of the proposed change to policy settings on the outcome is, in a sense, implicit in the policy design process, but is often less than rigorous and only rarely employs formal modelling. This flows through to evaluation. Sometimes reforms of this kind have a change process character where the policy change is temporary, for example, a program of fixed duration. The waterfront reform strategy of the early 1990s had these characteristics. Change process reforms are very difficult to subject to policy analysis. Indeed, they readily give rise to the suspicion that, because the policy has no identifiable lasting impact, it cannot influence behaviour and achieve the objective. Only once the change process is completed, can the effectiveness of the policy be judged, even then it can be very difficult to cost the diverse elements of which the reform may have been composed.³³

Combining and fine-tuning

These two reform processes may be combined or overlaid one on the other. Thus a change process program may accompany a simple policy change. For example, the Best Practice Program, a change process program, aimed to assist Australian companies to adjust to the more competitive business environment that simple policy changes like tariff reductions had introduced. The Best Practice Program could be seen as a facilitative measure that aimed at reducing the adjustment costs flowing from earlier reforms. This illustrates how the practical business of introducing policy measures differs from the idealised policy design process discussed earlier. Often the nature of the adjustment problems triggered by a reform will not be evident until well into the transition phase. There may be a case for fine-tuning a reform or introducing supplementary measures at this stage, if it can improve the outcome. Although being part way through the transition phase may make the task of examining this case complex, the policy design and evaluation principles discussed earlier still apply. Flexibility has its costs of course. Too great a preparedness to tinker with reform measures may invite continued lobbying against or complaint about the reform and slow the adjustment process.

³³ The Productivity Commission has recently completed such an assessment of waterfront reform, see PC (1998b). It tends to confirm some of the suspicions raised here about change process reforms.

Increasing sophistication evident in the approach to GBEs

As reform proceeded, attention focussed on the performance of the business enterprises owned by government, GBEs. Reform processes here were objective driven, but the approach was more sophisticated, attempting to isolate the aspects of GBEs that gave rise to poor performance. Measures deployed included changes to regulatory regimes (frequently to introduce more competition into some of the markets served by the GBE), changes to the GBE's financial structure, reporting and objectives (corporatisation) and changes of ownership (full or partial privatisation). Changes in GBE ownership had implications for performance through introduction of the disciplines of profit making and private capital raising and changes to corporate governance. But they also had important implications for the government budget, removing revenue streams and the requirement to fund capital spending, and for the subsidised provision of services to the community. These issues have often confused the debate about GBE reform. Taking proper account of them complicates the task of policy design and evaluation.

Jurisdictional complications increase complexity further

Although the Commonwealth government plays an important role as regulator and enterprise owner in areas such as air transport and post and telecommunications, the states hold sway in others, like land transport and energy. The states also play important roles in the provision of community services and environmental regulation. By the beginning of the 1990s it was becoming evident that further progress with reform required the cooperation of the states. As reform processes began to involve more than one level of government and the Special Premiers Conference, subsequently the Council of Australian Governments, moved to the centre of the reform stage, their complexity made a quantum jump. The national competition policy reforms provide a striking example. At the highest level these have involved agreements between the state and federal governments on a broad reform process, including funding incentives to the states to achieve certain agreed outcomes. These agreements facilitated changes to federal and state legislation and gave impetus to a variety of reform processes at the state level, each involving a number of individual reform measures.

Challenges to policy evaluation and design

Designing an approach to the analysis of such a complex process is clearly a daunting task.³⁴ Some of the reform processes now in train involve a number of discrete stages, for example, the reforms in electricity and rail. Here, although a broad overall plan is specified when reform is commenced, development of the detail of policy design takes place stage by stage and involves a process of testing and refinement, with the work at a particular stage often closely involving a body created at an earlier stage. For example, rail reform in New South Wales began by implementing the template recommended in the Hilmer report and broke the State Rail Authority into component businesses, being careful to separate the natural monopoly from the potentially contestable elements. With ownership of the track vested in the newly formed Rail Access Corporation (RAC), the reform process moved to determine an appropriate rate of return to be earned on RAC assets and to allow RAC to use open tenders to secure maintenance services. Both processes are involving a certain amount of learning by doing. The first is seeking to ensure both appropriate pricing for access to the track and investment in track and associated infrastructure at the socially optimal rate. The second has to manage the transition from a state-owned monopoly provider of services to competitive provision, where the community has an interest in the efficient provision of maintenance services, the value of the publicly owned entity and the social costs of adjusting to the changed arrangements. For reforms of this kind, comprehensive evaluation at the outset is out of the question. This raises the question of the basis on which the community would commit to the reform process. With this staged development of reform against a broad overall strategy, avoiding mixed signals to and ambiguity in the demands made on those affected by reform is a significant challenge for policy design.

4.5 Completing the circle

Stop the world I want to get off

This paper began by noting concern about growing public resistance to reform. Implicit in that concern is the judgement that continuing reform is required. Perhaps one factor contributing to growing resistance is an increasing questioning of that proposition. Does Australia need continuing reform? Three lines of argument suggest themselves. First, reform is necessary to provide the improved living standards Australians desire. Second, the world is becoming a more competitive

³⁴ The Industry Commission report that attempts to quantify the implications of the Hilmer reforms is an impressive size, see IC (1995).

place and unless Australia improves its performance it will drop behind. Third and most simply, it is pointless to waste resources and, if there is an opportunity to obtain a better outcome, it should be taken up. There are, of course, responses to each of these. But, regardless of the merits of the various competing arguments, what is undeniable is that this is an important question, one that ought to be the subject of serious public debate.

The role of policy analysis

There are some issues, integral to the debate about reform, that can never be resolved by policy analysis alone. The kind of society the community wishes to have is one such issue. Even here, however, policy analysis can make an important contribution by helping to identify the alternatives accurately. In seeking to ensure that policy analysis makes the fullest contribution to debate, it is tempting to assert that a sharp distinction needs to be drawn between analysis and advocacy. Deciding whether a proposed reform should be implemented inevitably requires more than the resolution of technical issues. It requires a judgement about what is best for the community. If a policy analyst is seen to be using the authority of that role to advocate a particular reform, questions about the objectivity of their analysis are inevitably raised: some may speculate that it was fashioned to support the advocacy rather than illuminate the consequences of alternative policies. Even so, concluding that an analyst should never be an advocate is simplistic. Analysts are also citizens who have the right to hold and express views about the alternative policies that the community may be contemplating. The community, perhaps more relevantly the media, expects its experts to provide simple answers to simple questions. Do we need national competition policy reforms, yes or no? Fully understanding the implications of the alternatives open to the community often requires a great deal of technical expertise. In such circumstances it is counsel that the community seeks not technical advice. Providing that counsel necessitates judgements about the relative merits for the community of alternative outcomes. Providing that counsel in a way that advances community wellbeing is a substantial challenge.

Some signposts

This paper has attempted to deal with some of the issues that arise in meeting that challenge. While no grand plan has emerged, some signposts to securing better outcomes can be gleaned. In summary, policy analysis should aim to:

- build confidence in the methodologies and techniques used to assess reforms
 - careful policy design and evaluation can assist in building support for reform;
- assess the ultimate distributional implications of reform carefully

-
- accepting that conclusions must be demonstrated to the satisfaction of the community not asserted;
 - be sensitive to the potential importance of equity and other considerations in community valuation of alternative outcomes
 - thoughtful, well presented analysis can help move constructively from generalised community concern to specific, efficient and effective policy measures,
 - costs of redistributive and other supplementary measures need to be highlighted to ensure sound community decision making,
 - a competitive economy is likely to be the best method to ensure gains are widely spread;
 - be aware that the community may wish to provide special compensation
 - due allowance needs to be made for it in evaluation;
 - assist the adoption of more effective delivery mechanisms by
 - identifying the alternatives,
 - using existing mechanisms where possible and having regard to their underpinning principles where new measures prove necessary,
 - looking for mechanisms that lock in support for and facilitate reform,
 - noting that poorly designed measures will create dangerous precedents;
 - be aware that policy design and evaluation are likely to get caught up in the iterative process of the community determining its valuation of alternative outcomes
 - they can best contribute by highlighting alternatives and trade offs,
 - a variety of data and analytic techniques can be used to derive alternative valuations to provide a focus debate;
 - investigate the adjustment implications of reform before implementation
 - using a variety of information sources,
 - noting that the benefits of reform can be importantly influenced by design of transition measures; and
 - combine adjustment measures and tune them to the adjustment issues arising from the reform in question.

Policy analysis must give priority to addressing the questions that the community considers most important, even where the answers are partial and inelegant.

References

IC (Industry Commission) 1995, *The Growth and Revenue Implications of Hilmer and Related Reforms*, Report to the Council of Australian Governments, AGPS, Canberra.

PC (Productivity Commission) 1998a, *Pig and Pigmeat Industries: Safeguard Action Against Imports*, Report no. 3, AusInfo, Canberra.

— 1998b, *Work Arrangements in Container Stevedoring*, Research report, AusInfo, Canberra.

5 Structural change, growth and ‘social justice’ — an essay

Wolfgang Kasper

5.1 Introduction: the focus on productivity growth

The primary assignment given the Productivity Commission by the Australian parliament is to investigate the factors that promote, and the obstacles that hinder, productivity growth in Australia. This work is to be done within an economy-wide setting (PC 1998, pp. 25–32). In addition, the government has given the Commission general guidelines. One should consider these as a list of secondary objectives which — as we shall see — may conflict with the pursuit of productivity growth: avoidance of social and economic hardships (however defined), the recognition of group interests, job creation, regional development, and ecological sustainability, amongst others.

There are trade-offs between productivity growth and equality of outcomes. A bias in favour of growth seems preferable from historic and international experience, amongst other reasons, because general, sustained productivity growth makes it possible and likely to advance the life opportunities of the poorest 10 or 20 per cent, whereas a preference for redistribution often undermines economic growth, so that the poorest 10 or 20 per cent, are worse off in absolute terms than under a growth strategy — for example, the poorest one or two deciles of Hong Kongers have a better material quality of life (longevity, health, security, education, nutrition etc.) than the poorest Tanzanians where equality was made a focus of long-term development strategy. Moreover, from a policy viewpoint, it is easier to obtain widespread agreement and deliver on productivity growth (and get re-elected) than to redistribute, that is, to confiscate and subsidise — an often politically divisive exercise.

This paper consists of two main sections. Section 5.2 is a freely structured essay that reflects the author’s conclusions from a life time of professional concern with growth and socio-economic change, as far as they affect the issue of compensation of selected economic agents for structural changes in the economy. Section 5.3 draws on these insights to address more specifically the question ‘to compensate or

not to compensate for the consequences of structural changes' and to give answers to the specific points raised by the Productivity Commission in the terms of reference. Section 5.4 concludes the paper. Because the issues raised cannot be satisfactorily analysed within the prevailing paradigm of neoclassical economics, which most trained economists implicitly adhere to, I include an appendix addressed to those who have to 'un-learn' simplistic and misleading basic economics (see appendix A5.1).

5.2 Productivity growth, competing and opportunity

Growth, knowledge, competition and conserving socio-economic positions

It can be taken as given that the growth of aggregate productivity and income requires structural change. As aggregate output grows, the component parts never increase proportionately. This is true whether we deal with a human body, a tree or a national economic organism. If natural structural changes are impeded by political interventions, then the spontaneous forces of economic growth are weakened; aggregate growth and job creation become sluggish. This obvious and fundamental fact is recognised both in the Commission's policy guidelines and its work.

For individuals and firms, a living, dynamic economy is inevitably an environment in which existing socio-economic positions are continually challenged. Positions of wealth, income or market share therefore have to be defended by continuing competitive and productive actions. In the final analysis, these very actions are the driving forces of ongoing growth. Some such actions may be innovative and push out productivity frontiers, others may be imitative and close gaps to productivity leaders.

To fully understand this statement, one has to realise that the ultimate source of growing productivity, income and wealth is the exploration and exploitation of new knowledge in a process of growing division of specialised labour and knowledge. Even the simplest of products — such as a pencil — require the coordination of numerous specialists (Kasper and Streit 1998, pp. 490–4). In a modern economy, the key reason for scarcity is limited human knowledge and a limited coordination of knowledgeable people. The central economic question therefore is how useful knowledge can best be found, tested and coordinated.

A broad-based advance of useful knowledge requires that numerous people dedicate — time and again — some of their resources to the search and testing of knowledge, to coordinating their specialised contributions and to monitoring

whether promised cooperation is actually delivered. Consequently, a large part of all costs of producing and distributing the national product of an advanced economy, such as Australia's, consists of coordination (or transaction) costs. Estimates for the United States show that well over half of all costs of producing and distributing the national product are coordination costs, rather than production or transport costs (Wallis and North 1986) and that their share has been rising steadily this century. These costs tend to be dominant in the rapidly growing service sector (now comprising some two-thirds of the Australian economy). Indeed, large and dynamic parts of the service sector are mainly in the transaction and knowledge-processing business. From this follows that overall productivity depends not only on productive efficiency in making products, but on the effectiveness of coordination and knowledge-finding processes.

The finding and testing of useful knowledge is risky business: if one invests one's resources in knowledge exploration, one never knows *ex ante* whether one will strike a bonanza, or fail. To know the usefulness of knowledge, one has to have incurred the knowledge-exploration costs in the first place (Arrow paradox). And once these costs have been expended, they are sunk: they have no relevance for whether or not that knowledge should be utilised (Kasper and Streit 1998, pp. 221–6). This means that there are no 'orderly' production functions for the production of knowledge, which would allow *ex ante* judgements on how many resources should be dedicated to a given exploration effort and what amount of useful knowledge is produced by a given exploration effort.¹ In reality, entrepreneurs have to make highly risky decisions based on often fuzzy expectations of expected costs and benefits and on gut feelings based on past experience.

Given the insidious nature of transaction costs, why should people who own resources incur such costs? The answer is self interest. Competitors force each other to seek favourable outcomes. Various suppliers rival with each other by searching for innovative products, processes and distribution methods, hoping to develop a market niche which allows them to earn good profits. They are likely to discover that niche profits are at best temporary, as rivals imitate their success. Likewise, potential buyers rival with each other in exploring knowledge by 'shopping around'.

¹ One consequence of this is that models — built essentially around known or assumed production functions, a concept which was derived from agricultural or industrial experience in a fairly static world (such as ORANI) — do not cover appropriately more than half of all costs. They exclude the most important aspects of what drives productivity growth! Standard econometric models, which necessarily incorporate only parameters derived from past experience, are also a hindrance to considering the economy as an evolutionary system which is open to unforeseen change.

As we shall see later in more detail, these insights derive from 'Austrian economics'. This body of knowledge is based on assumptions incompatible with the assumptions underlying the prevalent neoclassical paradigm.

Rivalry drives agents on both sides of the market to incur knowledge-exploration (or transaction) costs (Kasper and Streit 1998, ch. 8).

If one understands the motivations to shirk knowledge-exploration costs, one will understand that the notion that property rights are coupled to the obligation to compete is not popular. It is easy to gain political support by promising interventions which help competitors to avoid shouldering these costs. Yet, interventions to save competitors the cost of knowledge search make decentralised search processes less intense. As fewer people are involved in costly knowledge searching, many sources of spontaneous growth dry up. The ‘search engine’ of a competitive market economy then becomes dysfunctional. The history of Australia’s over-regulated economy for most of this century offers ample evidence for this (Kasper 1998, ch. 1). It is the interest in innovation and genuine enterprise that suggests a role for governments supporting active competition and desisting from shoring up monopolies and economic privileges.

The above implies that relevant knowledge can best be explored and tested by numerous, self-motivated people, that is, people whose individual actions are continually coordinated by evaluations of their expected costs and benefits. The alternative is *ex-ante* coordination and centralised knowledge-testing by coercive top-down coordination. This method is often more effective if the task at hand is non-complex. But *ex-ante* coordination normally fails in complex settings, such as national economies. The necessary knowledge cannot be centralised (Hayek 1945, 1978). In modern economies, it takes the commitment of almost everyone — producers, consumers, investors, savers and learners here and abroad — to master the knowledge task. This requires that the largest number of people are exposed to the discomforts of having to compete and to shoulder some of the requisite transaction costs. The more members of a community are granted political shelters from ongoing competition and from obligations to incur knowledge-search costs (for example, by compensation for costs), the less learning and the less growth there will be.

On the theory of economic growth

The evolution of theories about economic growth over recent decades has gradually absorbed these insights. In the 1940s and 1950s, growth was discussed in terms of static aggregate production functions. First, output growth was seen as a result of increased aggregate inputs of capital and labour, later inputs of physical and human capital, technology and natural resources were added. This yielded a body of macroeconomic growth theory which has become best known in the form Robert Solow gave it (see appendix A5.1). However, the theory proved unsatisfactory to

most practitioners of economic development. Australia's slow economic growth this century, for example, could hardly be explained by limited aggregate supplies of labour, capital, technology or natural resources. Many observers called for more promotion of research and development and skill formation, but often in abstract, summary ways ('clever country'). In reality, Australia's slow growth has been the result of structural rigidities and limited entrepreneurship which developed little demand for new knowledge and skills (Kasper 1978; Kasper et al. 1980, pp. 150–5). During the 1980s, it was increasingly accepted by economists that neoclassical growth theory might offer proximate explications, but could neither supply convincing explanations of the complex growth process nor policy recipes (OECD 1983).

In the meantime, microeconomic explanations of the processes of productivity growth have been nurtured by sources as diverse as economic history, the new organisation science, institutional economics, comparative systems theory and empirical experiences in the second and third worlds (see appendix A5.1). We now know that productivity growth is greatly influenced by institutional systems, that is, the rules of coordination and knowledge discovery. The relevant institutions cover both the *internal rules* of society, such as ethics, customs and work practices, and *external rules*, such as legislation and administrative regulations (Johnson, Holmes and Kirkpatrick 1999, pp. 1–20; Kasper and Streit 1998, pp. 13–21; Olson 1996). The 'institutional infrastructures' had long been taken implicitly for granted and were ignored by economists. But they determine transaction cost levels and the likelihood of knowledge discovery. The institutions decide whether people can cooperate productively or whether markets are dysfunctional in generating growth. They constitute the intangible software with which the more tangible 'hardware of growth' is made productive (see appendix A5.1). In recent years, some of this has been realised by policy makers, and institutional reforms have been central to the microeconomic reform strategy, for example, in reshaping national competition policy, simplifying trade protection rules or promoting the COAG reforms.

Economic growth is therefore not so much explained by the mobilisation of capital, labour, skills, technology and natural resources, but by the institutions which influence the costs and risks to entrepreneurs who test knowledge and adjust given economic structures. The costs and risks of innovation are none other than the coordination costs discussed above. They depend on the quality of internal and external institutions (rules), specifically, whether the rules are universal: general (ie non-discriminatory), certain (ie simple and knowable), and open (ie non-prescriptive, non-case-specific and applicable to future eventualities) (see appendix A5.1; Kasper 1998, pp. 51–2; Kasper and Streit 1998, pp. 122–4).

A rule system meets the criterion of universality, for example, if it secures private property rights, the freedom of contract and equality before the law. The principle of universality is violated with deleterious consequences for productivity growth by political preferences for one industry or another, this region or that, by opaque, complicated, changing rules, by case-specific *ad hoc* measures and the opportunism of political agents. Complicated rule systems fail the test of universality, as do all outcome-specific interventions. Seen in this light, Australia's comparatively poor economic growth performance for most of this century can be entirely explained by institutional deficiencies.

A related issue is the style of governance in moving to more universal institutions. Government reformers can be defensive-reactive, implementing only those piecemeal changes which new circumstances foist upon them. Alternatively, institutional reforms can be conceived on the basis of a cohesive system of fundamental institutions (a desired 'economic constitution') and then be implemented in a pro-active manner. Australian governments have frequently pursued the former strategy, the New Zealand government has — at times — pursued a principled and pro-active policy. It is an (as yet unanswered) empirical question which style of institutional reform is more successful in terms of growth, job security and sustainability.

It seems safe to predict that analyses of productivity growth will in future revolve increasingly around cultural institutions, law and administrative practices, the quality of governance of firms, banks and political entities, and economic liberties. We now have considerable, though far from perfect data to measure institutional quality. They invariably show a close correlation between the quality of institutions and the level and growth of productivity and income (see for example Gwartney and Lawson 1997; Johnson, Holmes and Kirkpatrick 1999; Kasper 1999; Sachs in *World Economic Forum* 1996, 1998).²

² These data collections are frequently criticised for being based partly on qualitative assessments by experienced business leaders and on other methodological grounds. Over time, some of these criticisms have been addressed by better statistical techniques. Another set of criticisms comes from economists – such as Paul Krugman – who (correctly) contend that nations do not compete as corporations do. But none of the protagonists of these data collections have ever said so! Jurisdictions compete by supplying institutions of differing quality as a location-specific asset to attract mobile resources (such as capital, knowledge and enterprise), and owners of mobile resources judge, each and everyone for their specific case, which institution set promises the best location-specific return by keeping their transaction costs low. Neoclassical economists, of course, habitually fail to understand interjurisdictional (institutional) competition, because their assumption of 'perfect knowledge' makes them blind to transaction costs and institutions! (compare appendix A5.1). Practicing business leaders and policy makers, who do not suffer from the 'neoclassical economics distortion', increasingly use the above-mentioned data sets for predictions and policy making, and the correlation of these, albeit tentative, data with actual

How to keep 'evolutionary windows' open

The central importance of appropriate institutions can be understood when one realises that they shape the evolutionary capacity of a society and an economy — or what is sometimes called its 'evolutionary window'. It is widely agreed that progress, globalisation, technical and social changes and Australian institutional reforms have placed great demands on the evolutionary adaptiveness of Australian economic and social structures. Changed circumstances and trend breaks make it impossible to predict the future and responses to change are now hard to coordinate constructively and creatively. This has bred a widespread feeling of disorientation and insecurity. What is needed in this situation is a set of confidence-inspiring, reliable and simple rules which widen 'evolutionary windows'. What is needed for example is a consistent enforcement of private property rights — rather than new limitations to promote specific prescriptions and regulations and frequent rule changes (see section 5.3).

Every society develops along an evolutionary path determined by cybernetic feedback from past experience and driven by emerging inconsistencies and innovative initiatives. The wider the evolutionary window, the easier it is for individuals and businesses to cope constructively with social, technical and economic challenges. But how open that window is to future evolution is greatly influenced by country-specific social and political factors:

- (a) *Age structures*: The young generation tends to favour changes even if they inflict short-term cost, if long-term yields can be expected. The old (say more than 60 years of age) tend to resist change. And the middle-group tends to mediate between those interests. It commands the resources to bring change about. Ageing therefore tends to go along with a narrowing of the evolutionary window, as Europe and Japan demonstrate. While Australian demographic trends move in the same direction, our evolutionary window looks comparatively more open to the future.
- (b) *Reliance on markets*: The more economic coordination is driven by top-down administrative directive, the more likely is it that precedent and risk aversion become dominant, whereas entrepreneurially driven, open competitive systems favour spontaneous, flexible experimentation within a system of shared rules. An economic system based on private choice provides clearer incentives and therefore has a better evolutionary-innovative capacity: The spread from profit to loss is commensurate to the task of risk taking and motivates people to incur the transaction costs of widespread knowledge search. With administrative, collective-choice, decision makers face the penalty of reprimand for

growth performance has – so far – stood the test of time. (For analytical relevance and some details of the methodology see Kasper and Streit 1998, pp. 343–9.)

misjudgments, but they are not rewarded for gains from risky decisions they took (Hayek 1945, 1978). This asymmetry explains why top-down command systems of coordination have an inferior evolutionary capacity and produce systematically poorer growth outcomes.

Microeconomic reforms shift the emphasis from the top-down coordination to market coordination and therefore open evolutionary windows. This does not happen painlessly because many citizens have stakes in past structures and often have to develop the mental attitudes and the networks that turn them into successful competitors (see, for example, the costly learning processes during Australia's financial deregulation in the 1980s).

- (c) *Rent seeking and political distribution*: Political monopoly games and rent seeking are promoted by organisations with a stake in past socio-economic conditions, whereas open, decentralised market competition widens evolutionary windows on the future (Buchanan, Tollison and Tullock 1980; Olson 1982). Where the institutions fail to suppress political privileges and where clients of the state are given the feeling that they 'own' a market under government license, it is only natural that compensations are demanded when new competitive challenges infringe on market shares or profitability. Political rent creation thus leads to institutional sclerosis — evolutionary windows are being shut. Compensations for (some) structural changes are an example of discriminatory redistribution which reduces the incentives to incur the transaction costs of competing. An institutional order that stresses property rights, self-responsibility and the freedom of contract will, by contrast, widen the evolutionary window.
- (d) *Dynamic feedback*: As we shall see below, there is a dynamic feedback mechanism. Past rigidity inspires resistance to change. More people then hold visions of the future that make them 'future haters' (Postrel 1998), and fewer have the confidence, the capabilities and the appetite for embracing innovation.

Whilst ageing processes, a heavy reliance on the visible hand of government and a culture of rent trading have narrowed the evolutionary window in Australia, the opening of the economy to more trade and investment has countered these influences. A more open economy has overcome much institutional sclerosis and paved the way for political entrepreneurs who adopt decontrol, privatisation and similar institutional streamlining as their program. The new openness to trade and investment has also focused our minds on the competition among different institutional systems: which institutional conditions enable Australians to succeed in competition with market rivals who operate from a differing institutional platform? The Asian set-backs have also driven home the point that the provision of an evolution-friendly set of 'institutional software' has to be a priority for success in long-term economic competition (Kasper 1999; Patten 1998; World Bank 1998).

The key to future economic success now lies frequently in low transaction cost levels, which depend on good institutions and trustworthy governance, rather than on low production costs.

To summarise this subsection: No one can be sure of future trends and industry structures. But in the face of ongoing and cumulative structural changes in the world, Australians will greatly benefit from keeping the evolutionary windows as wide open as possible. Governments do not know enough to prescribe by which windows we should move into the wide-open future. But they can do a lot to keep the evolutionary windows open.

A paradigm shift

What has been said so far implies a fundamental shift in the economic paradigm. Indeed, such a paradigm shift from static neoclassical to dynamic evolutionary or institutional economics is under way worldwide, although the Australian economics culture seems to suffer from a learning lag.

Given the cognitive difficulties of academic and bureaucratic analysts and the huge amounts of intellectual capital invested in neoclassical theory, the acceptance of the paradigm shift will take time. Nonetheless, even parts of the Australian public service have begun to query the old, shared concepts (DISR 1998). International organisations (eg World Bank 1998) and experienced politicians here and overseas have moved much further down the track to evolutionary-institutional economics.

Competition and coordination tend to be better understood by practitioners than formally trained economists. They do not assume the knowledge and coordination problem away (see appendix A5.1). They often find economists unconvincing because they still adhere to the unrealistic assumptions of the neoclassical paradigm. One example to demonstrate this was the bizarre and inconclusive spectacle of conflicting econometric models to ‘prove’ whether free trade or continued protection would be good for the Australian car industry during the most recent Industry Commission inquiry of that industry. The exercise only demonstrated that dummy variables and assumptions of ‘perfect knowledge’ are no substitute for real knowledge! Nor can comparative static models, which assume that there will be no major parameter changes because they assume openness to total surprises away, come to grips with the complex, open phenomenon of economic growth and systems reform. The reputation of economics (and, by the way, the Productivity Commission) with the Australian public and policy makers

will not survive too many more such farcical modelling exercises!³ It is high time that the analysis of productivity growth — a dynamic phenomenon — is conducted within a realistic, evolutionary economic framework and that comparative-static models and theories are pulped.⁴

The problem of structural adjustment is, by its very nature, a dynamic-evolutionary phenomenon. What matters are transition paths, rigidities and speeds of adjustment — all matters which are the subject of evolutionary inquiry and to which comparative-static equilibrium models have little, if any, practical relevance.

Before the economic aspects of growth and structural change can be pursued further, it seems appropriate to make brief reference to basic philosophies and political valuations which have influenced the Australian debate about growth and structural change.

On basic philosophy: collectivism versus individualism, reactionary versus pro-active attitudes

When addressing economic growth, structural change and tax-funded compensation for some structural changes, one cannot avoid at least a brief, explicit discussion of normative issues. The public debate is often cast in terms of a discussion of efficiency *versus* equity, frequently on the (wrong) assumption that one can have economy-wide productivity growth without ‘iniquitous’, ‘socially unjust’ challenges to existing socio-economic positions. The discussion typically (and wrongly) assumes that one can know the effects of growth on distributional outcomes.

As we shall argue later, winners and losers cannot be known in a dynamic, evolving world with a complex division of labour. Frequently, the assumption is made that

³ A similar exercise was the recent inconclusive parade of econometric models before parliamentarians to show the effects of a GST. These models failed to specify transaction costs, nor did they allow an assessment of how tax reforms affect the evolutionary capacity of the Australian economy.

⁴ For an up-to-date exposition of institutional theory see Kasper and Streit (1998, chs 5 and 6). See also Boettke (1994); Hodgson, Samuels and Tool (1994).

It seems symptomatic that the key journals on institutional economics can hardly be found in Australian public libraries — among them the venerable, 155 year old *Journal of Institutional and Theoretical Economics (JITE)*, the *Journal of Law and Economics*, *Public Choice*, *Ordo*, the *Journal des Économistes et des Études Humaines*, and *Constitutional Economics*. Likewise, even a cursory inspection of the catalogues of Australian public libraries reveals that the key monographs of this new, dynamic discipline are poorly represented in this country — an indicator of a cultural lag in economic education.

there is necessarily a conflict between these two aspirations. However, there are many reforms such as the promotion of widespread education, which further efficiency and equity. Likewise, the promotion of genuine competition typically forces the rich to risk some of their wealth on transaction costs and offers poor newcomers opportunities to gain income and wealth. As noted elsewhere there is convincing empirical evidence that countries with a tradition of redistributive interventions have more lop-sided income and wealth distributions than truly competitive countries such as Taiwan (IMF 1998).

The notion of tax-funded compensation seems to imply a norm that economic structures should somehow be stable as defined by a multiplicity of characteristics — industry, employment, regional, social group, wealth distribution, ‘class’ etc. But the norm is change. The norm is structural ‘insecurity’, because numerous circumstances change all the time. Self-reliant, free citizens must be expected to prepare for the eventualities of ongoing change. No form of collective action could ever protect people from change, even if the community were prepared to sacrifice all economic growth! As a wit once put it: ‘For things to stay the same, we must change all the time!’.

Instead of the unhelpful and inaccurate focus on efficiency and equity, one should analyse current debates about microeconomic reform in terms of another pair of social visions: reactionary-collectivist *versus* dynamist-individualist attitudes.

Collectivism is based on the view that many details of our complex world need to be ordered from the top down by leaders and their advisers (however selected and legitimated). It is based on an implicit belief that central authorities are able to obtain and digest all relevant knowledge, and that they have the ‘common good’ at heart, rather than being self-seeking opportunists in pursuit of their own political goals.

These two assumptions are rarely realistic.

The opposing individualist world view is normally tied to a preference for dynamism and diversity. The dichotomy between reactionary and dynamist value sets is now playing a growing role in political controversies around the world (Postrel 1998; Sowell 1987, 1995):

- (a) A reactionary is typified by a fear of new technology, new competitors and the outside world, indeed a fear of liberty and responsibility. Reactionaries tend to rate the expected costs of change highly and value the expected benefits low. Collective power tends to be called upon to conserve the past (Postrel 1998). In Australia, the reactionary stance can be found equally among ‘One Nation’

supporters, the churches, public-welfare lobbies, and authors who call for collectivist constraints on economic freedoms, such as Fred Argy (Argy 1998).⁵

- (b) The protagonists of a dynamist world vision are confident that free people can interact spontaneously to improve things and to achieve a more highly valued joint output. They welcome the opportunities of new technologies, new business connections, open competition and diversity in goods, skills, equipment and talent, including diversity offered by competitors outside the community. They prefer institutional arrangements that permit and encourage individual action and knowledge search.

Adherence to one world view or the other tends to be self-reinforcing. Individuals who operate in dynamic free market environments receive a continuing training in how to succeed and find their biases confirmed by success, whereas interventionism and rigidity tend to strengthen pessimism about future possibilities. Such feedback determines the evolutionary window which a community shapes for itself.

5.3 Problems of tax-funded compensation

‘Thou shalt not covet ... anything that is thy neighbour’s.’

From the Tenth Commandment

In its terms of reference, the Productivity Commission formulated a number of specific questions concerning structural change and the compensation of certain agents, groups or regions who are perceived to have incurred material losses as a consequence of market-driven and/or policy-driven structural changes.

Before we can go through the questions in the terms of reference, however, we have to clarify what is meant by ‘structural change’ and define ‘compensation’. Many of the Productivity Commission’s questions have common answers, which flow from what has been said in section 5.2. We therefore will present a discussion of the fundamental problems of compensation, as well as the pre-conditions that will have to be met before compensation schemes can be implemented, before turning to the Productivity Commission’s detailed questions.

⁵ Oddly, Argy has labelled his preferred position, which is reactionary in the lexicon of authors such as Sowell and Postrel, as ‘progressive liberalism’!

On structural change

In section 5.2, we noted in passing that the notion of ‘structure’ is many-faceted. Structure has to be defined both as to the detail of disaggregation and the relevant structural characteristics, if one is to contemplate compensation measures.

Most frequently, structural change is analysed at the fairly aggregate level of ‘an industry’ (say at 4-digit ASIC level). This is an abstract which rarely fits factual decision making or ownership structures. Industries are, at best, given factual substance when represented by industrial organisations or lobby groups. But, of course, not all decision makers are organised at the industry level. Many belong to different industries. In fact, much of what happens in the process of structural change and economic growth occurs at a much greater level of disaggregation, at the level of enterprises, divisions within enterprises, plants, products, workplaces and regionally dispersed market places. In reality, structural flexibility — factor mobility guided by profit-loss incentives — is made at the micro-micro-economic level. It can be effectively influenced by policy interventions only to the extent that the visible hand can reach down to that level. Yet, administrators tend to be blind to the detail at the relevant level. The gains and costs of structural adjustment which impact at the micro-micro level are normally beyond the cognitive reach of centralised policy.⁶ Does the spread of chain stores impose product uniformity or open opportunities for complementary, small specialists who offer new diversity? What about quality improvements in cars, fabrics, household equipment, capital goods and services? What gains are produced by service providers that now communicate much more detailed market information? The real gains of structural change are generated in that detail, often without becoming visible from the aggregate heights of the academic observer, the journalist, the statistician and the policy maker. Reactionaries who demand top-down policies to curb structural change, typically ignore these micro-micro level gains from change (Postrel 1998).

A further problem with designing policies to handle structural change is that the same aggregate can be broken down according to differing characteristics: industry classification, employment category, social class, income and wealth group, location, political affiliation, etc. If policy makers are asked to discriminate according to some, but not other structural criteria, they not only break the constitutional maxims of universality and equality before the law, but also violate notions of equity according to other structural criteria. Compensation of one industry for loss of socio-economic position due to economic growth (eg hoof-smiths or Australian bulk steel producers) may infringe notions of ‘social justice’ as

⁶ In a most insightful article on this issue, Scott (1998) discusses how cognitively challenged state organs respond to their knowledge problem. They tend to introduce costly ‘state simplifications’ and impose top-down designs to the detriment of people on the ground.

judged by employment structures or ethnic criteria. Redistributive policies to enhance 'social justice' invariably rely on selective definitions of 'material outcome justice', typically as represented by well-organised, politically active groups. 'Cosmic justice' is a logical impossibility (Sowell 1987, 1995). The compensatory state can never avoid creating, by its very actions, some injustice somewhere else. And in the process it undermines private property rights and all the benefits that flow from its protection. The only feasible concept of justice is to apply the same rules to all equal cases and circumstances and to strengthen the equality of all before the law (Kasper and Streit 1998, pp. 78–80; Sowell 1987).

The term 'compensation' clarified

According to the *Oxford Dictionary*, 'compensation' is a payment or other amend for someone's loss. Compensation implies a specific loss and demonstrated link with a specific amendment. In what follows, we will discuss compensation in the first-mentioned, normal, narrow sense of the word.

Sometimes in the Australian policy debate, the term 'compensation' is given a wider meaning, namely general measures that facilitate overall economic growth and give losers a better chance to recover their economic position thanks to better market opportunities or less dysfunctional markets. ('The government introduces labour-market reforms to compensate industry for the loss of tariff protection'.) When we refer to such measures we shall use terms such as 'general growth policies' or 'enhancement of the spontaneous forces of economic growth'.

Problems of compensating for structural changes

Were it to be accepted that government is to intervene in structural change by compensating 'losers' (and penalising 'winners'), then transparent, adjudicable rules would have to be spelled out how to define losers and winners. When that is attempted, it quickly becomes apparent that the choice of definitional characteristic for structure is difficult. In reality, it is normally determined by political convenience. Thus, re-election motives may lead to the choice of regional characteristics. Or fund-raising considerations for a political party may lead to a choice of industrial identity as a criterion for compensation. Compensation for structural change no doubt enhances political and bureaucratic career opportunities and leads to rent-seeking. But, as all selective political intervention, it tends to go against the long-term common interest of a free society in wide-open evolutionary windows and fast economic growth. Redistribution by political fiat (either by confiscation and hand-out, or by intervention in market processes) interferes directly with private property rights and therefore directly undermines the

competitive system which promises most productivity growth (Kasper and Streit 1998, pp. 304–7, 317–24). There may be valid political grounds to redistribute incomes and wealth, but it must be understood that this will be at the expense of economic growth.

It is often argued — as Karl Marx did — that a competitive capitalist system leads to an intolerably skewed distribution of incomes and wealth, and that the goal of long-term social and political stability justifies redistributive interventions. This argument does not stand up to the facts. Countries with more interventionist policies tend to have more uneven income distributions than free market economies. This important empirical fact can now be documented thanks to the growing availability of statistical evidence (Johnson, Holmes and Kirkpatrick 1999, pp. 10–15). Economies that are governed by a liberal and universal constitution of competitive capitalism — such as Taiwan — display a fairly even spread of wealth and incomes, because upward mobility enhances social harmony. In such systems, the political machine does not protect organised socio-economic positions, so that outside challengers can join the competitive fray at lower transaction cost and have a better chance of succeeding. In intensely competitive regimes, people with wealth are continually challenged to incur the transaction costs of innovation. Often, markets prove their bets wrong or at best temporary (section 5.2). This is why great fortunes rarely survive over generations in competitive systems. Enhanced, spontaneous growth in competitive systems also leads to higher levels of employment and hence economic opportunities for the weaker competitors. By contrast, poor growth in interventionist-reactionary institutional settings has the side effect of preventing certain groups from escaping unemployment and the concurrent loss of socio-economic position.

One can also view the issue of compensation for structural changes in the context of whether a community's life should be run according to the economic rationale of individual choice and material opportunity for everyone, or according to the political rationale of favouring 'la classe politique'. Political agents are more important if much economic coordination relies on political action. There is more scope for the self-seeking promotion of political careers and there are fewer controls of political agents by the citizens, who are the principals of the state.⁷

⁷ Political principal-agent problems, if not effectively addressed, lead to widespread citizen cynicism, as evident in contemporary Australia. This can pave the way for political instability (compare Kasper and Streit 1998, pp. 324–32).

An example, which suggests caution about this side effect of pervasive reliance on top-down ways of coordinating people, is the Weimar Republic in Germany. The political game in the 1920s was carried out by a parliament pandering to ruthless, egotistic industrial or union lobbies. This ensured that ordinary citizens became alienated from democracy. They stood by cynically

When discussing the costs and benefits of structural change and possible compensation for certain changes, one must also be aware that many of the benefits of ongoing change are taken for granted (eg better quality products and the creation of jobs in new activities) or are attributed to personal entrepreneurial prowess, whereas the losses are readily attributed to structural change and policy action. The lop-sided recognition of the costs and benefits of structural change has various consequences:

- (a) The costs are exaggerated by ‘loser lobbies’ in order to qualify for compensation. And rent-supplying political agents will exaggerate the costs to justify drawing on scarce public resources.
- (b) Offers of compensation strengthen reactionary attitudes at the expense of dynamist viewpoints, narrowing evolutionary windows. This in turn aggravates perceived and actual structural problems.
- (c) The policy interventions themselves become reactive-conservative. Policy makers pander increasingly to well-organised, though declining industries and regions, rather than being pro-active and change-promoting (OECD 1983). The activities of the future normally have no vote yet. Entrepreneurs who are building new growth industries are in any event too busy and often lack the resources to incur the high fixed transaction costs of political lobbying.
- (d) Where the collective management of structural change extends to the selective promotion of future winners, government agents inevitably suffer from cognitive and motivational limitations. Instead, they imitate what have turned out to be winners elsewhere, causing over-capacities and poor profitability (OECD 1983). This has justifiably given structural policies ‘to pick winners’ a bad name (Hughes 1997-98), but not necessarily deterred self-seeking Australian advocates of industry policy.

The conclusion from all of this is that policy makers committed to the common good and long-term productivity growth should be extremely cautious about any form of compensation.⁸

when populists destroyed democracy. ‘One Nation’ voters and other ordinary Australians now appear to have similar feelings about our parliamentary democracy.

⁸ A 1979 Australian government report (the Crawford Report) argued for detailed interventions in industry structures, tacitly assuming that government agents can obtain all relevant knowledge for measures such as specific industry plans and that there will be no political opportunism in administering such plans. The Australian experience with industry policy since then should make one extremely weary whether these tacit assumptions ever hold true (Hughes 1997-98).

To compensate or not to compensate?

The notion that government should compensate private economic agents for structural changes or consequences of certain policy shifts is a by-product of neoclassical welfare economics (see appendix A5.1). Italian economist Vilfredo Pareto (1848–1923) had built a model based on static and extremely unrealistic assumptions — such as known and homogenous indifference curves, universal knowledge of all production possibilities, no innovations, zero transaction costs, no principal-agent problems, no market intermediaries, and no entrepreneurial challenges to existing constraints — in order to squeeze the diversity of economic life into a simplistic mathematical model (Machovec 1998). This gave rise to the concept of ‘Pareto optimality’ and the notion that allocational improvements can be made as long as no one was worse off — in practice until millions of people in a national economy had reached optimum satisfaction from millions of different products and many diverse types of productive resources! This kind of theorising later gave rise to the idea that those who make allocational gains should compensate losers in the interest of ‘Pareto optimal’ fine-tuning. Gradually, less stringent compensation criteria — such as those by Kaldor and Hicks — were introduced, furnishing further theoretical arguments for compensation. But the analysis was always based on a comparative-static lifeless nirvana that has little to do with a complex, continually evolving reality! No one — and certainly no political agent — can have the knowledge to calculate ‘proper’ compensation, because the transient gains and losses cannot be known or measured.

It seems useful to list the numerous fundamental and practical problems with compensation that flow from a more realistic concept of economic life. Advocates of publicly funded compensation would have to solve all of these problems before tax-funded compensation could be contemplated:⁹

- (a) If a government in pursuit of the long-term common good were to compensate for policy impacts, should it also compensate people for the consequences of inaction and non-reform?
- (b) There is the question of the time horizon over which the costs and benefits of a policy change — even if they could be known — are to be measured: three months, three years, a decade? This question makes it clear that the notion of compensation is based on a static image — a snapshot — of what in reality is always a dynamic phenomenon in a film.
- (c) Should the impacts of partial reforms be measured *ceteris paribus*, ie disregarding earlier or subsequent reforms? An affirmative reply to this

⁹ During work on this subsection, I benefited greatly from an unpublished paper by Geoffrey Jones of Victorian Treasury (Jones 1999).

question means, for example, that a previously protected industry is given compensatory hand-outs after tariff cuts, but that it is not selectively taxed for the profit-enhancing effects of subsequent labour or tax reforms.

- (d) Reform measures often affect the rich more than the poor. Should compensation out of public revenues be paid to affluent shareholders who have capitalised the discounted value of tariffs or other artificial privileges, including foreign owners of multinationals? If not, is this not a violation of equality before the law and an unjust treatment of some citizens?
- (e) Even if administrative rules could be written to allow the definition of a loss from a policy shift or a structural change: How can such a loss be proven in a court of law? What criteria of proof should be laid down to constitute a legal case for a recognised loss? Who should carry the burden of proof in conflicts over the interpretation of such rules? Should loss be defined in absolute terms (ie as a diminution of income flows or wealth), or in relative terms (ie relative to a changing national average or some other changing benchmark)?
- (f) If compensation is paid, should the resulting moral hazard be tolerated? Should the administration compensate for certain losses after a policy change, even if it is evident that those losses were brought about with the connivance of the loss-maker, simply in order to qualify for loss compensation?
- (g) It is frequently quite unclear what constitutes a benefit or a loss. If a general region such as the Lower Hunter is rid of the handicap of a dominant shrinking industry, such as bulk steel, is this its loss or gain? The answer depends on whether the change initiates dynamic creative responses or whether expected compensations induce rent seeking by regional interests.
- (h) Since objective economic criteria for compensation cannot be found, economic rationale will often be replaced by political rationality (the use of power and the seeking of rents). As we saw, this tends to undermine overall productivity growth and the material opportunities of everyone. This poses the fundamental question whether the poorest quarter of the population is better off with fast growth and open opportunities, or rachitic growth but an agreed measure of outcome equality. International experience indicates that institutions which widen evolutionary windows of opportunity typically enhance the life opportunities of the poor, whereas interventionism typically benefits well-organised groups and established interests.
- (i) Who is to bear the tax burden of compensation, and how does that affect popular perceptions of justice and equity? Maybe, advocates of regional or industry compensation should be invited to cost their proposals in units of dialysis or heart-lung machines.

-
- (j) How does the diversion of tax resources into subsidies affect the international competitiveness of all producers in a country over the long run?
- (k) Sometimes one hears the pragmatic or opportunistic political argument that compensation payments to affected groups or regions serve to eliminate political resistance to reform. This argument is short-sighted and reeks of political expediency. As we saw, biddable governments invite noisy political resistance to adjustment. In well-established political communities, such as the Australian, private organisational capacities and social cartelisation invariably outrun government's capacity to supply compensation packages (Olson 1982). The lesson of history is that policy makers must never promote political 'hold up risks', just as paying the Mafia protection money is dangerous and immoral. Political leaders must always ask: How will the opportunistic 'buying off' of well-organised interest groups affect social cohesion and stability in the long term?
- (l) Should compensation be paid for the withdrawal of previous subsidies and political preferments? Can an affirmative answer be justified to those whose life opportunities have been diminished by past policy discrimination?¹⁰ If an industry, for example, were compensated for the loss of tariff protection, should one not compensate the long-suffering victims of past tariff discrimination, the customers?
- (m) Should adjustment payments be made conditional on certain actions by subsidy recipients? If so, how can compliance be monitored and credibly enforced? What penalties do government agencies have to enforce compliance once the subsidy has been handed out?
- (n) Like all rent trading, the political compensation game is bound to impose high transaction costs (administrative and judicial resources, diversion of private effort into lobbying, confusion about the fundamental economic rules which raises information costs). These transaction costs do not serve the finding and testing of useful knowledge, but constitute deadweight costs.
- (o) The compliance costs in pursuing government hand-outs are invariably high and fixed. Should one accept that it will be the big firms with legal departments and good access to the agents of government who obtain compensation, whereas small enterprises go without because they cannot afford the fixed compliance costs?

¹⁰ In the history of ideas, this argument paid a big role in the 19th century when slave owners demanded compensation for the loss of property after the abolition of slavery. The plea was roundly defeated in various European countries after the likes of Alexis de Tocqueville pointed to the sheer immorality of such compensation.

These problems seem intractable to this observer. The decision rules and criteria for using tax resources to compensate certain groups cannot be known. If others advocate or demand compensation schemes they must provide practical solutions.

Question 1: Should governments distinguish between (a) policy-induced structural adjustments and distributional effects, and (b) market-driven changes?

A distinction can generally not be made because policy- and market-induced changes are part and parcel of the same ongoing economic processes. Structural changes occur continually due to a great multiplicity of factors (Kasper 1982, pp. 86–8), and it is normally impossible to isolate the consequences of one change in circumstances from the consequences of all the others. In a continually evolving, complex economy, it is not possible to attribute quantified consequences to one factor — such as a policy change, and to prove this in a court of law under normal judicial procedures. In any event, the burden of proof would be on the claimants, not government agencies.

The compensation proof by claimants will be harder to provide if policy actions are phased in over time, if there are a multiplicity of concurrent changes, and if political agents desist from case-specific commitments and discriminatory actions which have to be undone subsequently by microeconomic reform.

In a rapidly changing world, a specific material consequence can be attributed to a cause beyond reasonable doubt only in exceptional circumstances, for example when a policy change was major, specific and stepwise. But even then it is questionable that this should lead to compensation. After all, protection from change — from whatever source — is not an actionable right of citizens. If policy makers were to recognise such a right, this would lead to endless claims for compensation, political auctions of privileges, and a stagnant, stale economy (see section 5.2).

Provable consequences of policy-induced changes may justify compensation of citizens under the rules of Australian common tort law in cases where government agents have misled citizens. But this should be no concern of the Productivity Commission, it is a matter for private claims in the courts of the land.

The likelihood of compensation claims for policy changes is reduced greatly if policy makers confine themselves to cultivating a general institutional framework for markets and avoid ‘outcome engineering’ and targeting specific firms, industries or regions (as was indicated in section 5.2, there are many other reasons for such an approach to policy). General, universal rules benefit, for example, from trade

liberalisation, factor and product market deregulation and the simplification of industry regulations.

Question 2: How should adjustment costs and distributional issues be treated in evaluating specific policy changes?

Generally, with benign neglect.

It is normally not feasible to differentiate *ex ante* between different classes of adjustment costs and attribute them to specific policy measures. There is simply no way to even know all adjustment and distributional impacts in a complex, openly evolving economic organism (see section 5.2). Econometric modelling — based on continuities, the assumption of closed, rather than openly evolving economic systems, averaging, aggregation and dummy variables — is certainly not suited to furnish the relevant knowledge (appendix A5.1).

When adjustment and distributional impacts occur in concentrated form, the consequences are frequently softened by the tax system. Remaining impacts on private citizens, if they lead to poverty, may best be compensated by the social welfare safety net. Policy makers may wish to go further to alleviate some selective impacts of market competition. In this case, they are well advised to focus on enhancing the spontaneous functioning of markets, for example, by providing better information or subsidising the incurring of transaction costs of certain market participants. Examples of this type of action would be the provision of labour market information and the subsidisation of job search by unemployed people. But policy makers should be advised that more specific action typically exceeds the knowledge collective agents can have, may induce moral hazard in that market participants begin to shirk their own responsibility to incur transaction costs and induces political opportunism. The almost consistent failure of specific welfare schemes here and overseas to reach predefined, specific goals lends substance to the advice that one has to be extremely cautious when trying to bring about specific welfare outcomes. This should, in my opinion, however, not be a concern of the Productivity Commission. Under its charter, the priority should be given to productivity growth on the assumption that — over the long run — most citizens will benefit from high growth and high employment (section 5.2).

Particular adjustment problems occur where flows of rents have been capitalised in asset values. For example, artificial political constraints on taxi licences have been capitalised in high prices for taxi plates, and tariff preferences have inflated the share price of car producers. However, on closer analysis, this happens all the time in living market economies, as every shareholder knows. People who buy and sell assets cannot insist that they are protected from such changes, and subsidy seekers

must not be allowed to construe a right to compensation when the hand-outs and interventions cease, lest many markets become dysfunctional and nearly everyone suffers (section 5.2).

Productivity-promoting reforms which result in a more universal economic rule system and which undo past political discrimination and favouritism, should not be hindered by inconclusive, drawn-out political debates about equity or regional impacts, most of which are unknowable and unprovable. It is this observer's considered view that gainers and losers (whether main or secondary) from a policy change cannot — and should not — be identified as part of the preparation of new policies. Where political leaders require their advisers to adhere to given — and clearly defined — targets of equity, policy advisers should transparently show the growth consequences of such targets and leave it to elected decision makers and the general public to make choices between equity and growth.

Attaching higher weights to the (organised) interests of the losers than to the (often unorganised) interests of the winners of policy reform violates the principle of equality before the law. Such discriminatory weighting of the interests of some and not other citizens by government will, in the final analysis, delegitimise growth policies. Such social engineering also leads to unforeseen, deleterious side effects, and encourages moral hazard on the part of politicians and citizens, induces people to act so that they become visible losers and so that the number of possible losers is increased. In open economies, such attempts induce the exodus of capital, skills and technical knowledge to more enterprise-friendly institutional environments.

A reactionary approach to reform — which relies on compensation, but negates efficiency gains — should not be contemplated by the Productivity Commission. It violates the Act. Besides, governments lack the knowledge to assess the magnitude of the consequences of reforms and are in any event rarely powerful enough to do much about structural change.

One good way for policy changes to reduce adjustment burdens is to implement many broad-based reforms concurrently, so that individual producers' costs and benefits are affected simultaneously. As product and factor markets are decontrolled simultaneously, impacts on profit rates are less than, for example, in the case of an isolated tariff cut.¹¹ There is of course much literature on 'optimal sequencing' of reforms. But it is based on the mistaken assumption of knowledge about time lags, as Sir Roger Douglas of New Zealand pointed out when he wrote:

¹¹ The failure of Australian and New Zealand governments to institute concurrent reform on all major fronts is, in my opinion, the major reason for the prevalent reform fatigue.

A great deal of technical debate has been aired worldwide about the optimum sequencing of structural reform, and the alleged sequencing errors of governments... Armchair theorists postulate the desirability of tackling the labour market or the tradeable goods market before embarking, for example, on the deregulation of sectors such as finance. At a purely analytical level the debate is entertaining, but no clear-cut messages emerge. Moreover, from my point of view as a practitioner, the question is irrelevant. Before you can plan your perfect move in the perfect way at the perfect time, the situation has already changed. Instead of a perfect result, you will have a missed opportunity.

Some decisions take full effect on the date they are made. Others take two to five years' hard work before they can be fully implemented. Perfect sequencing is just not achievable. If a window of opportunity opens up for a decision or action that makes sense in the medium term, use it before the window closes! (Douglas 1990, p. 4)

To reiterate, a major lesson from institutional analysis is that policy makers should not even try to analyse the specific consequences of specific reform measures because they can do little about them and should not be tempted to promise what collective action cannot deliver. Rather, they should implement universal, expedient rule systems and allow the consequences to take care of themselves.¹² The primary role of policy is to make changes predictable for citizens. This suggests gradual reforms and pre-announcement of changes where supply structures are affected. Anything more ambitious is only likely to hinder overall productivity growth and inflict unforeseen side effects.

Such an institutional approach to policy obviates the need to place burdens of proof on anyone. It supports freedom and self-responsibility and greatly reduces the transaction costs of change.

Question 3: Microeconomic reform and the opening of evolutionary windows

The thrust of much of this essay so far has been to argue for the overdue and creative destruction of established mental models that underpin much economic policy advice in Australia. The reason for this thrust is that economic and econometric policy advisers in Australia who have argued so often from a basis of neoclassical orthodoxy no longer carry much weight in convincing public opinion and influencing the thinking of policy elites (see section 5.2 and appendix A5.1).

However, the basic philosophy expounded here suggests a number of important principles and procedures for the conduct of public policy:

¹² This approach was called 'order policy' in post-war Germany (see Kasper and Streit 1998, ch. 10c). The approach is now gaining popularity in America and Europe under the label 'constitutional economics' (Kasper and Streit 1998, ch. 10g).

-
- (a) In an open, fast-changing and increasingly diverse economy, policy must be designed with the fundamental fact of cognitive limitations in mind. Both policy makers, who intervene and try to engineer specific outcomes, and those subjected to policies are only able to understand and obey simple and fairly steady rules. Microeconomic reforms, which change familiar rules, are naturally perceived as a cognitive burden, in particular when the overall mission of the reform strategy is not clearly explained or when different agents of government pursue contradictory policies. It is not an easy task to gain public support for liberalising institutional changes, in particular after an era of dirigism and reliance on the wisdom of government agents (Douglas 1990).

The first rule therefore must be: ‘Keep it simple and general!’ As we said, specific consequences of given rules or rule changes should not concern government agents. We recognise, however, that there will always be political temptations to exploit specific consequences of reform for self-seeking political advancement.

- (b) Simple, consistently enforced rules should, above all, give substance to secure private property rights, the freedom of contract and equality before the law. These time-tested institutions need to be given overriding precedence over interventions in specific market processes (order policy, constitutional economics). However, this will only happen when it is widely understood that most outcome-specific policies retard overall productivity growth in which all Australians have an overriding interest.¹³

The maxim that the role of government (including the courts) is to protect simple, non-discriminatory institutions does not amount to *laissez-faire*. Government agents can do much to reduce information and other transaction costs by streamlining laws and approval procedures, by encouraging markets that generate valuable information or even by providing information to market participants. An example of a reform that allows markets to provide valuable information has been the liberalisation of money and capital markets. They now signal emerging changes effectively whereas traditional financial regulations deprived Australians of much useful intertemporal information. Governments can also alleviate compliance costs, an avowed aim of government policy, but one which most governments around the world have spectacularly failed to pursue.

¹³ One class of outcome-specific policies is now widely perceived as being particularly prejudicial to productivity growth and opportunities for the young and the poor: welfarist redistribution, be it through tax-subsidy transfers or the more pernicious means of interfering in market processes (Kasper 1998, pp. 106–9). The level and diversity of public welfare provision in Australia therefore needs to be reduced if we are to enjoy an internationally competitive and growth-supporting institutional system.

-
- (c) Much institutional research (which is reported in the journals mentioned in footnote 4) is now being conducted into the design of rules of good governance and transparency. Political voting procedures, legal and tax reforms, the facilitation of quality codes of business conduct, financial auditing, corporate governance, share-holder and takeover rules, and institutions governing share market and financial derivative markets are areas that now receive intensive attention from institutional economists around the world. Procedures that help to control agent opportunism in government and that make government agencies more responsive to change can also reduce the coordination costs of private citizens and firms and within government, build trust and open evolutionary windows.
- (d) Many of the institutional reforms now under discussion are not confined to government-made and government-enforced rules. Important functions of rule making and enforcement can be left to citizens and firms interested in particular institutional arrangements (eg professional self-regulation). Thus, there may be arguments for greater reliance on private-competitive forms of conflict mediation: reliance on private, competitive arbitrators, instead of public monopoly courts. An example of how effective and expedient such competitive arbitration can be is the experience in international trade: more than 90 per cent of all private international trade disputes go before (competing) private arbitrators, who act expediently. And 90 per cent of their rulings are accepted. To attract business, they compete by offering simple, known rules. This allows traders to get on with the business, in contrast to drawn-out, costly court cases (Kasper and Streit 1998, pp. 357–61).
- (e) One way of facilitating overall growth and easing possible adjustment losses is for governments to confine themselves to ‘generic development policies’: offering general encouragement to mobilising capital and labour; knowledge and natural resources; and ensuring that supply in factor markets is elastic. It has then to be left to private entrepreneurs to use these factor supplies by picking winners and ditching losers in the light of their valuations of expected benefits and costs. This generic style of growth policy would, for example, focus on removing double-taxation and other disincentives to saving and capital formation and encourage the generation and testing of knowledge, but desist from selective and specific industry or trade policies. Generic growth policies demand much less specific knowledge of policy makers and are less likely to lead to corruption in government and industry. The shift from specific industry intervention to factor mobilisation has been a part of the success of many East Asian economies, and relapses into specific industry or project promotion in Asian countries (crony capitalism) has much to do with the present set-backs in Asia.

-
- (f) Governments can also open evolutionary windows for entrepreneurs by the design and impartial, expedient enforcement of stable, general rules on depreciation, corporate governance, take-overs and bankruptcy. Unavoidable entrepreneurial failures need to be quickly liquidated, so that resources tied up in failed experiments can be quickly redeployed.
- (g) A style of economic policy which focuses on the quality of rules and is extremely cautious in intervening selectively in market processes reduces the transaction costs of competing and innovating. Transaction costs — more than half of all costs — should be a prime consideration in all economic and social policy. Australians can compete successfully in the world only on the basis of low production *and* transaction costs. Australian parliamentarians, judges and administrators often ignore the consequences of their actions on the transaction costs of international competitors and producers. Instead, they design policies with administrative convenience in mind, not even to enhance the importance and the income of public agents. But the incomes of public agents are often the transaction costs of private business.
- (h) A separate important issue in institutional reform is whether the judiciary (as well as quasi-judiciaries, such as the industrial-relations industry or industry boards and agencies) can be made aware of the obstacles to productivity improvements which they so often erect. One way out of the drift to a more dirigist, litigious, high-cost institutional setting is simpler law (Epstein 1995).

The terms of reference list numerous sub-questions to question 3. Some were addressed in section 5.2 and specific segments of section 5.3 (eg the case for gradualism, the case for pre-announcement, the case for broad-based reform and problems with specific compensation). Others betray the (neoclassical) naivete about the knowledge problem, presuming knowledge about economic causes and effects which is unrealistic. These specific sub-questions therefore need not be addressed again.

5.4 Conclusion

To this observer, the only philosophy of how to manage structural change is to stick with the time-tested understanding that all citizens and firms have to live with the consequences of numerous, ceaseless changes, including some changes to which policies have contributed. In a free society of responsible citizens, the basic understanding must be that everyone has to expect ongoing structural changes. The challenges to existing socio-economic positions will never cease. Government provision of general social insurance or even selective insurance against changing

circumstances would only destroy the very foundations of a free and prospering society.

All that governments can do in a continually evolving, complex world is to help enhance the mobility of labour, human and physical capital and other resources and to ensure that resource uses are guided by flexible and clear price signals. Government agents must not arrogate to themselves knowledge about anything more specific and more prescriptive than that.

The adjustment burdens of citizens and firms can and should certainly be eased by reforms that are pre-announced, well explained and gradually implemented. Governments should concentrate on cultivating the credible, simple rules of private property, free contract and equality of all citizens before the law and stop second-guessing market agents who risk their own time and property. Back-tracking and inconsistencies in institutional reforms — such as the recent extension of the tariff discrimination against car buyers — increase the adjustment burdens on the general public.

Economists and government advisers have an important role in promoting institutional reform. An essential first step is to stop pretending that they have superior knowledge and are able to submit policy advice full of specific recommendations. The advice that the consequences of specific actions cannot be known will often suffice to stop resolute politicians and bureaucrats from implementing interventions. And the advice that certain policy actions will reduce overall productivity growth and raise unemployment would sometimes also inhibit interventionism. In Australia, this requires a culture change. This is part of the very style of policy which has impeded productivity growth in Australia and elsewhere.

Many policy makers do not readily accept that less is more. Policy makers need to learn how to concentrate on the few tasks they are good at and stop pretending that they can engineer many different specific outcomes for different client groups. The cultivation of trust-inspiring and firmly enforced institutions does not amount to mere deregulation, but to the provision of simple, citizen- and business-friendly regulation.

Thanks to time-tested social, legal and political British traditions and despite the dirigiste fashions of the past two generations, Australia seems reasonably well-equipped to pursue such a constitutional-economics-strategy. And Australians will need to, for they live in a frontline state in the intensifying international competition with new industrial countries. Australians have a good chance of winning many of these contests because overseas competitors are often handicapped by much more deep-seated institutional deficiencies. If we get our rule system right, we will

compete successfully, and particularly in the rapidly growing service industries where universal institutions are crucial to competitive strength.

The prosperity, the long-term sovereignty, the freedom and the social stability of the Australian community over the next generation will depend on institutional innovation. Committing to specific compensation schemes would be a retrograde step.

A5.1 Growth, change, institutions and public perceptions

for victims of Eco 1.01

The demise of the neoclassical paradigm

The neoclassical economic paradigm, which was shared by most economists and policy makers (including most Australian policy advisers) for most of this century, has come under increasing attack in recent years. It has failed to explicate phenomena such as the huge international differences in economic growth rates or the collapse of Soviet-style socialism. Nor can it provide satisfactory theoretical underpinnings to microeconomic reform, privatisation and public-sector reforms (Kasper and Streit 1998, chs 13–14).

The economists who have influenced the world-wide policy reforms since the 1970s have come from other theoretical backgrounds, namely Austrian and public-choice economics (see Hodgson, Samuels and Tool 1994). A growing number of Economics Nobel Prizes have been awarded to critics of the neoclassical paradigm. Economics Nobel laureate Ronald Coase wrote recently that ‘[m]ain stream economics ... has become more and more abstract over time, and although it purports otherwise, is in fact little concerned with what happens in the real world.’ He goes on to emphasise the insight to which (paleo-) classical liberals, such as Adam Smith, dedicated their efforts, namely that ‘the productivity of the economic systems ... depends on specialisation ... [and] exchange — the lower the costs of exchange ..., the greater the productivity of the system. But the costs of exchange depend on the institutions of a country’ (Coase 1998, pp. 72–3). In a similar vein, prominent British economist Mark Blaug castigated modern economics, which he called ‘sick’, because it was emptied of real-life content such as entrepreneurs, evolution, transaction costs, genuine innovation, and an understanding of dynamic competitive rivalry. In particular, he ridiculed ‘the cloud-cuckoo land of perfect competition’ (Blaug 1998, p. 7). British economist Geoffrey M. Hodgson made the same point when he subtitled a recent book *Bringing Life Back into Economics* (Hodgson 1993).

Others have shown that the aberrations of the neoclassical abstraction began with Léon Walras (Machovec 1998) and that it is now a body of knowledge which no practitioner — whether oil tycoon, real-estate agent, or fish shop owner — can possibly relate to. Business schools and courses in commerce and law have reduced their standard economics content because it is not relevant to their pursuits.

The new policy fashions — such as public choice, Austrian, evolutionary and institutional economics — have, of course, also been adopted into Australian policy, but frequently without an explicit rejection of standard neoclassical economics or without a full understanding of the inconsistencies of assumptions between the new theories and the familiar neoclassical paradigm. The outcome is that reformers often sound contradictory, are often not sufficiently convincing, and give inconsistent advice.

The declining influence of the neoclassical mainstream to the policy debate goes back to the counter-intuitive abstraction of a perfectly informed *homo oeconomicus* who maximises or minimises known goals and utility with the help of perfectly known resources and who is free from the continuities of past evolution (Kasper 1997, 1998, pp. 25–42). The central difference between neoclassical and the newer (and much older) bodies of economic theory is the theoretically convenient, but abstruse assumption of perfect knowledge. In reality, economic life revolves around discovery. It is a search for procedures which enhance the use of knowledge and the effective division of labour and knowledge (as Coase, above, pointed out). Economic agents do not simply maximise given aspirations by given means, they constantly discover new wants and resources to satisfy them. Scarcity is a dynamic concept. Economic agents are therefore in reality rarely motivated by a narrow end-means rationality — with the ends and the means readily known — but by bounded and entrepreneurial rationality (Kasper 1997; Kasper and Streit 1998, pp. 53–65). They make their decisions within the bounds of available, but limited knowledge and take risks to overcome existing constraints. This is entirely rational behaviour.¹⁴

Institutional economics

The realisation that economics is about discovery has further important consequences. One has to acknowledge that coordination/transaction costs are considerable and that principal-agent problems exist everywhere. In a modern, evolving economy, the exploration and testing of knowledge absorbs considerable resources, so that concepts like ‘market-clearing price’ and frictionless exchange need to be abandoned. And where agents act for others, limited knowledge on the part of the principals and superior knowledge on the part of the agents often tempts agents to behave in opportunistic ways, normally at the expense of the principals (principal-agent problem).

¹⁴ The term ‘economic rationalist’ was originally applied by sociologists and other critics to neoclassical economics and the perfectly informed, unrealistic *homo oeconomicus*. In Australian popular usage, the term has now become a vacuous all-purpose invective against people who argue for economic liberties and individual responsibility.

These complications cannot be assumed away as in the neoclassical paradigm. They constitute the core of the economic problem. They are typically tackled by the creation and enforcement of institutions, ie rules of conduct whose violations incur some sort of sanction (Kasper and Streit 1998). Institutions can evolve by trial and error within society (*internal institutions*, such as ethical norms, customs or work practices) or can be designed and imposed by political agents from above (*external institutions*, such as legislation or administrative rulings). Rule violations may incur informal sanctions (spontaneous self-enforcement, such as loss of reputation, tit-for-tat response, or the exclusion of violators) or formal, which means organised, sanctions (such as legal penalties). Appropriate institutions help people to economise on transaction costs and contain their opportunistic instincts, thus enabling a more effective division of labour and a better exploration of new knowledge — in other words, they facilitate productivity growth.

As long as a community lives in isolation, poor quality institutions can be tolerated. Policy elites need not learn about the harm which poor governance inflicts. Thus, ancient Egypt or China could live under the arbitrary rule of men and with the repression of individual economic freedom for thousands of years. In open economies, knowledge about the consequences of institutional differences, however, spreads. The rulers and ruled alike are then exposed to learning experiences. This is so because merchants, investors and entrepreneurs with high organisational skills will engage in arbitrage between different institutional environments. This affects growth rates both in countries which attract and which lose mobile factors and whose international trade competitiveness is affected. The visible growth consequences produce learning feedbacks to policy makers and interest groups. Openness enhances their cognitive capacities and motivations, and thereby widens evolutionary windows.

Admittedly, openness and institutional innovation are often resented, because traditional institutions are highly valued. After all, people have adjusted to existing rules, and numerous interests are affected by institutional changes. Australians have made this experience since globalisation began to coincide with long-delayed international trade liberalisation and a partial deregulation of domestic markets. Transiting from the traditional institution set to an open, competitive economy is not easy. It is more costly if some segments of the economy are exempted from the need to adjust.¹⁵

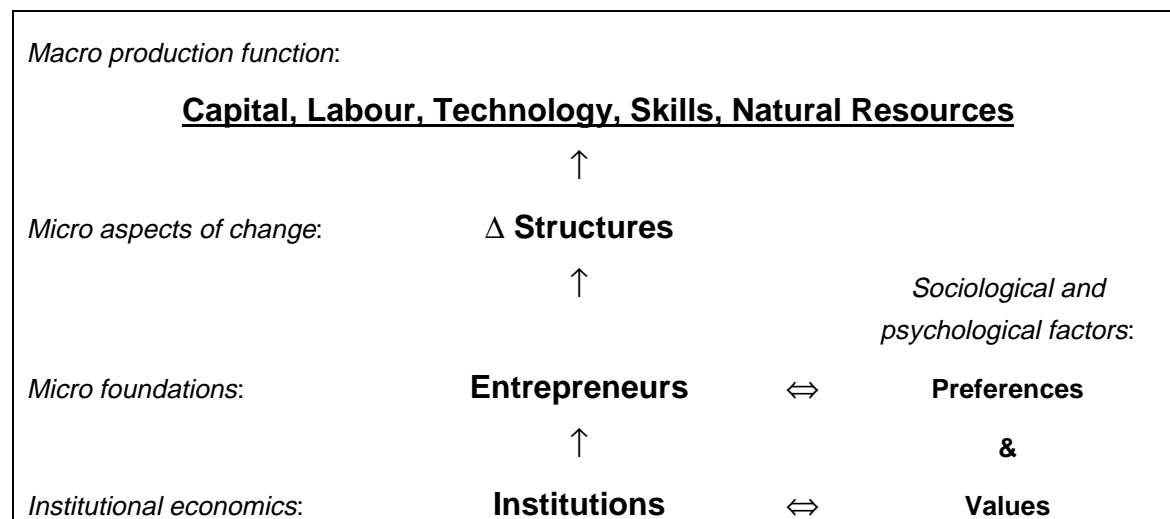
¹⁵ Australia's institutional quality detracts from our international competitiveness, despite the fact that our measured institutional deficit is less here than that of many East Asian economies. In Australia's case, the institutional deficit is caused mainly by poor labour-market institutions and deficient ratings on openness to trade and capital movements (Johnson, Holmes and Kirkpatrick 1999; Kasper 1999; World Economic Forum).

The new 'growth theory'

These fundamental theoretical considerations have overturned the theory of economic growth during the past twenty years. Economists who are unaware of the long traditions of Austrian, evolutionary and institutional economics, have dubbed these developments 'the new growth theory'. In reality, the new theories spring from long traditions of analysis. The development of growth theories can be summarised in a nutshell with reference to figure A5.1:

- (a) Neoclassical growth theory focused on macroeconomic factors, namely the mobilisation of aggregate capital, labour, technical knowledge (which was assumed to fall miraculously 'like manna from heaven', as Joan Robinson believed), skills and natural resources. These inputs and the output of real national product were discussed in terms of a production function with typically positive, but decreasing marginal rates of return (Solow, 1988). The model offered scant policy advice. It also suggested that additions to inputs would add once-off, but decreasing additions to output, until the uninspiring state of the 'golden age' was reached – stagnation. Explanations of what mobilises macroeconomic inputs and how they get combined were not offered.

Figure A5.1 **Conditions of economic growth: an overview**



Source: Adapted from Kasper and Streit (1998, p. 20).

- (b) Microeconomic, structural changes which regularly occur during the growth process were accommodated in the model by assuming systematic relationships between income levels and structural characteristics (Chenery and Syrquin 1975; Kasper 1978). While this allowed the discussion of key growth conditions, such as factor mobility and price flexibility, it essentially saw causation the wrong way round: aggregate growth was seen as being the cause of systematic shifts in microeconomic structures, rather than flexible microeconomic changes adding

up to measured growth. Moreover, these theories begged the question: What drives microeconomic changes?

- (c) The answer to that question is entrepreneurship and competition in the sense of people being driven to incur the transaction costs of knowledge search. The theory of competition and entrepreneurship gives genuine microeconomic substance to growth theory and allows economists to derive policy advice on how to raise the growth rate permanently.¹⁶

The theory became fully operational with the explicit addition of institutional reform. Institutional changes can pave the way for more entrepreneurial action and drive microeconomic activities in directions which are more highly valued, as measured in economic growth.

- (d) This type of reasoning led US economists — such as Clower (1998), Romer (1986), Lucas and Sachs (both in World Economic Forum 1996, 1998), and Barro (1991) — to formalise and test the growth influence of institutions, such as the rule of law, corporate and public governance, and the freedom of contract. They now speak of ‘increasing returns to economic growth’, since the contribution to growth-enhancing knowledge is improved with active entrepreneurial practice and since institutional infrastructures improve with use. There is a solid, positive association between institutional quality (economic liberties) and the level of incomes as well as the rate of growth (Beach and Davis, in Johnson, Holmes and Kirkpatrick 1999, pp. 1–20; Gwartney and Lawson 1997). Even the World Bank has now begun to adopt the new institutional growth economics (World Bank 1998).

The policy implications of the new growth theories inspire much more optimism than Robinson-Solow-type theories ever did: they tell us that the cultivation of appropriate institutions makes for sustained and more rapid improvements in productivity and living standards. Rule systems are needed that invite as many property owners as possible to compete and act entrepreneurially and that expose as much of the economy as possible to voluntary private, rather than coercive collective coordination. They also tell us that political redistribution — for example to compensate perceived losers of structural changes — undermine the universal

¹⁶ The concepts of discovery and innovation are crucial in this context. It is not a matter of a fully informed economist-observer analysing which technology the producers will choose from a range of known options at the start of each period, as neoclassical economics would have it. Rather, technologies and resources are often genuinely unknown, also to the economist. As Israel Kirzner has pointed out, growth relies on genuine discoveries, and not just on information search within known parameters (Kirzner 1997). Besides, technology and other structures evolve along certain paths where past choices limit the innovations which producers can contemplate (Kasper and Streit 1998, p. 38).

guarantee of property rights and the growth-generating capacity of the market economy.

These insights about economic growth can only be conveyed to the wider public convincingly by analysts who understand the behavioural foundations of the new evolutionary-institutional economics and who have jettisoned the neoclassical figment. The necessary paradigm shift requires economists and organisations, such as the Productivity Commission, to scrap a considerable part of their intellectual capital—a tall-order transaction cost indeed!

References

- Argy, F. 1998, *Australia at the Crossroads: Radical Free Market or a Progressive Liberalism?*, Allen & Unwin, Sydney.
- Barro, R.J. 1991, 'Economic growth in a cross-section of countries', *Quarterly Journal of Economics*, vol. 106, pp. 407–43.
- Blaug, M. 1998, *The Disease of Formalism in Economics, or Bad Games That Economists Play*, Lectiones Jenenses No. 16, Max-Planck-Institute for Research into Economic Systems, Jena, Germany.
- Boettke, P.J. (ed.) 1994, *The Elgar Companion to Austrian Economics*, E. Elgar Publishing, Aldershot, UK.
- Buchanan, J.M., Tollison, R.D. and Tullock, G. (eds) 1980, *Toward a Theory of the Rent-Seeking Society*, College Station Texas A&M University Press, Texas.
- Chenery, H.B. and Syrquin, M. 1975, *Patterns of Development, 1950–70*, Oxford University Press, London.
- Clower, R.W. 1998, 'New microfoundations for the theory of economic growth?', in Eliasson, G. and Green, C. (eds), *Microfoundations of Economic Growth — A Schumpeterian Perspective*, University of Michigan Press, Ann Arbor, USA, pp. 409–23.
- Coase, R. 1998, 'The new institutional economics', *American Economic Review*, vol. 88, no. 2, May, pp. 72–4.
- Crawford report. See Study Group on Structural Adjustment 1979.
- DISR (Department of Industry, Science and Resources) 1998, *A New Economic Paradigm? Innovation-Based Evolutionary Systems*, DISR, Canberra.
- Douglas, R. 1990, 'The politics of successful structural reform', *Policy*, vol. 6, no. 1, pp. 2–6.
- Epstein, R. 1995, *Simple Rules for a Complex World*, Harvard University Press Cambridge, USA.
- Gwartney, J. and Lawson, L. 1997, *Economic Freedom of the World 1997*, Fraser Institute, Vancouver.
- Hayek, F.A. 1945, 'The use of knowledge in society', *American Economic Review*, vol. 35, pp. 519–30.
- 1978, 'Competition as a discovery procedure', in Hayek, F.A., *New Studies in Philosophy, Politics, Economics and the History of Ideas*, Routledge, Kegan Paul, London, pp. 179–90.

-
- Hodgson, G.M. 1993, *Economics and Evolution — Bringing Life Back into Economics*, University of Michigan Press, Ann Arbor, USA.
- , Samuels, W.J. and Tool, M.R. (eds) 1994, *The Elgar Companion to Institutional and Evolutionary Economics*, E. Elgar Publishing, Aldershot, UK.
- Hughes, H. 1997-98, 'Industrial policy for Australia', *Policy*, vol. 13, no. 4, Summer, pp. 10–16.
- IMF (International Monetary Fund) 1998, *Should Equity be a Goal of Economic Policy?*, IMF, Washington D.C. [This summary essay gives references to insightful, detailed issues paper.]
- Johnson, B.T., Holmes, K.R. and Kirkpatrick, M. 1999, *1999 Index of Economic Freedom*, Heritage Foundation and Wall Street Journal, New York.
- Jones, G. 1999, Should we compensate the losers from economic reforms?, Paper prepared for the Centre for Independent Studies seminar 'Advanced Liberty and Society', CIS, Sydney, 19–21 February, mimeo.
- Kasper, W. 1978, 'Australia's economic and industrial structures: past patterns and prospective trends', in Kasper, W. and Parry, T.G. (eds), *Growth, Trade and Structural Change in an Open Australian Economy*, Centre for Applied Economic Research, University of New South Wales, pp. 90–129.
- 1982, *Australian Political Economy*, Macmillan, Melbourne.
- 1997, 'Ignorance, discovery and choice — a requiem for economic rationalism?', *Australian Journal of Legal Philosophy*, vol. 22, pp. 1–14.
- 1998, *Property Rights and Competition - An Essay on the Constitution of Capitalism*, Centre for Independent Studies, Sydney.
- 1999 forthcoming, 'Rapid development in East Asia: institutional evolution and backlogs', in Thillainathan, R. (ed.), *Financial Markets and the Future of the Asian Miracle*, Kuala Lumpur.
- et al. 1980, *Australia at the Crossroads, Our Choices to the Year 2000*, Harcourt Brace Jovanovich, Sydney.
- and Streit, M.E. 1998, *Institutional Economics — Social Order and Public Policy*, E. Elgar Publishing, Cheltenham, UK and Manchester, MA.
- Kirzner, I.M. 1997, 'Entrepreneurial discovery and competitive market process: an Austrian approach', *Journal of Economic Literature*, vol. 35, no. 1, pp. 60–85.
- Machovec, F.M. 1998, 'Paradigm lost: the Walrasian destruction of the classical conception of the market', in Eliasson, G. and Green, C. (eds), *Microfoundations of Economic Growth — A Schumpeterian Perspective*, University of Michigan Press, Ann Arbor, pp. 29–56.

-
- OECD (Organisation for Economic Co-operation and Development) 1983, *Positive Adjustment Policies: Managing Structural Change*, OECD, Paris.
- Olson, M. 1982, *The Rise and Decline of Nations: Economic Growth, Stagflation and Social Rigidities*, Yale University Press, New Haven, CT.
- 1996, 'Big bills left on the sidewalk: why some nations are rich, and others poor', *Journal of Economic Perspectives*, vol. 10, pp. 3–24.
- Patten, C. 1998, *East and West*, Macmillan, London.
- PC (Productivity Commission) 1998, *Annual Report 1997–98*, AusInfo, Canberra.
- Postrel, V. 1998, *The Future and Its Enemies — The Growing Conflict over Creativity, Enterprise, and Progress*, Free Press, New York.
- Romer, P. 1986, 'Increasing returns and long run growth', *Journal of Political Economy*, vol. 94, pp. 1002–37.
- Scott, J.C. 1998, 'Freedom and freehold: space, people and state simplifications in Southeast Asia', in Kelly, D. and Reid, A. (eds), *Asian Freedoms*, Cambridge University Press, Cambridge, pp. 37–64.
- Solow, R.E. 1988, *Growth Theory: An Exposition*, Oxford University Press, Oxford-New York.
- Sowell, T. 1987, *A Conflict of Visions*, William Morrow, New York.
- 1995, *The Vision of the Anointed*, Basic Books, New York.
- Study Group on Structural Adjustment 1979, *Report of the Study Group on Structural Adjustment*, (J.G. Crawford, Chairman), AGPS, Canberra.
- Wallis, J.J. and North, D.C. 1986, 'Measuring the transaction sector in the American economy, 1870–1970', in Engerman, S.L. and Gallman, R.E. (eds), *Long-Term Factors in American Economic Growth*, Chicago University Press, Chicago.
- World Bank 1998, *East Asia — The Road to Recovery*, World Bank, Washington.
- World Economic Forum (various), *The Global Competitiveness Report*, World Economic Forum, Geneva.



6 Issues in structural reform

Elizabeth Savage

6.1 Introduction

The goal of microeconomic reform is to raise productivity and community living standards. However, the process of reform is unlikely to be costless. Structural changes associated with reform result in adjustment pressures and costs. Inevitably, some groups in the community lose.

This paper discusses how adjustment problems should be addressed from the perspective of modern public economics. In economic terms, the goal of microeconomic reform is to raise the welfare of society. It seems reasonable to assume that most societies care about distributional outcomes, so government policy should reflect this concern. While the aggregate (or average) living standard in the community is one determinant of social welfare, it is not the only one. The level of social welfare also depends on the pattern of welfare across the distribution *and* society's ethical judgements regarding inequality.

Governments intervene in many areas of the economy because the market performs badly, either with regard to distributional outcomes or because of what economists term market failure — the inability of the free market to provide correct incentives to promote an efficient allocation of resources in certain, well-specified circumstances.¹

The best way of approaching the task of raising community welfare depends crucially on assumptions made regarding the policy instruments available to

¹ When there is market failure, the economy is not allocating its resources in the most productive way. There are a number of conditions that must be met for the market outcome to bring about an efficient allocation of resources. No individual, or coalition of individuals, must have power to set prices. This rules out monopolies, cartels and any collusive agreement to set prices. Private firms must also be capable of providing all socially valued goods or services at market prices that correctly signal the social cost of production. In summary, if free market outcomes are to be efficient, there must be no market failure. Furthermore, the market price of each good or service must reflect the social cost of producing the last unit and the social value attached to the last unit consumed for all consumers.

government. If the government has access to the full set of instruments then it can achieve the maximum level of social welfare without imposing any adverse efficiency impacts from its policies. This policy setting is called first best. However, as observed by Laffont (1989, p 167):

In characterizing these (first best) policies, we have endowed the government with a cornucopia of very powerful political economic instruments, such as personalised taxes and lump sum transfers, that often surpass the informational capabilities or jurisdictions of the government or that neglect the necessary incentive requirements which any economic system encounters.

First best simplifying assumptions allow the analysis to focus on a single issue. The notion that individual market failures can be addressed by individual policies, treating them in isolation and ignoring distribution, is referred to as piecemeal reform. If the underlying assumptions were met, this approach would be welfare improving.² However, one of the most important results of the economics of the second best is that piecemeal application of first best policies cannot be guaranteed to increase social welfare.

Prior to the 1970s, almost all public finance employed first best assumptions. The public finance orthodoxy was virtually rewritten during the two decades following the path-breaking papers of Mirrlees (1971) and Diamond and Mirrlees (1971a, 1971b).³ The modern public economics literature demonstrates that the application of policies appropriate to a first best world will, most likely, lead to inefficient (and inequitable) outcomes. In the policy debate in Australia, errors of this kind are common. Many policy disagreements in areas of public economics can be traced to one side implicitly adopting first best assumptions and the other recognising second best constraints.

Policy design should reflect the more complex world in which we live. Second best environments require explicit consideration of phenomenon such as imperfections in markets, uncertainty and distributional issues. To design welfare improving policies, the government must identify attainable outcomes and rank policy options

² If the first best conditions hold, the policy framework consists of two distinct stages. In the first, the government corrects market failure to bring about efficient resource allocation. In the second, the government redistributes endowments so that the operation of competitive processes results in the preferred efficient outcome. Equity need not be considered when policies are introduced to correct market failure. Efficiency is not relevant when the government redistributes because endowments can be reallocated without imposing any price distortions or efficiency costs. In summary, equity and efficiency concerns can be completely separated.

³ See any modern public economics text for discussion of the central results. Advanced level texts are Atkinson and Stiglitz (1980); Tresch (1981); and Myles (1995). Undergraduate texts are Stiglitz (1988) and Rosen (1992). For an overview see Savage (1998b).

taking into account both equity and efficiency.⁴ It is standard practice in all areas of public economics to consider the welfare impact of changes to the distribution of resources in society *when policy reforms are designed*. In practical policy settings, the separation of equity and efficiency considerations is not defensible.

There is considerable resistance on the part of many participants in the Australian policy debate on microeconomic reform to accept that all practical policy settings are second best and that a broader set of policy instruments reflecting distributional outcomes is required. However, many within the community appear more willing to see desirable policy goals in broader terms.

A policy reform enhances efficiency if the sum of welfare gains to winners exceeds the sum of welfare losses to losers. To make a judgement about the efficiency impact of a policy, it is necessary to have estimates of these individual welfare gains. Yet many participants in the policy debate make efficiency judgements without this information. They fail to demonstrate the sign or size of the efficiency impact. Instead, they rely on a set of 'rules' that are inappropriate and misleading in second best settings.

This is very relevant to the issue of how adjustment costs should be addressed. A fundamental issue that arises is whether there is a valid basis for addressing 'losses for some groups' separately from structural adjustment policies that are seen as yielding 'benefits for the community at large'. The standard practice in modern public economics is to address these losses when microeconomic reform is planned. It is inappropriate to introduce a reform irrespective of its impact on the distribution of welfare and address unfair outcomes using a separate policy instrument (such as compensation via the social security system).

In welfare economics, there are no 'benefits for the community at large'. There are only benefits to individuals and these are aggregated to determine social gains. The impact of a structural reform on social welfare (and efficiency) needs to be demonstrated using the best techniques and data available. Claims of benefit to the community at large are unlikely to lessen public resistance to reform without empirical support.

Adjustment pressures impact on the welfare of community members. If welfare costs result from a policy intervention, the aggregate net welfare gains and the distribution of gains should be considered when the policy is designed. The government should use the most effective policy instruments available. If there are

⁴ Savage (1993) illustrates this procedure for a number of policy options regarding the income tax threshold.

adverse welfare impacts arising from market-based structural changes, the appropriate set of policy instruments is likely to be more restricted.

Evidence for social gains flowing from improved efficiency, higher productivity and growth of GDP are likely to be more effective in reducing community resistance if supported by empirical results from independent researchers representing a range of constituencies. If the community perceives that the assumptions underlying the government's analysis of policy outcomes are unrealistic, the need for independent validation is even greater.

To address adjustment and distributional issues, it is necessary to clearly set out the welfare economic framework for policy. While the framework is probably familiar to those involved in policy design and evaluation, there are a number of confusions that, if clarified, explain opposing views on the evaluation process. These relate to assumptions made concerning the goals of microeconomic policy reform and the policy instruments that are available to government in realistic policy settings.

Section 6.2 of the paper sets out some of the major issues and gives a broad overview of the current orthodoxy in public economics. This body of economics builds on the observation that unregulated market activity does not achieve a socially optimal outcome. Successful policy interventions rest on adequate theory and good design/implementation. Adequate theory takes account of practical constraints on the government's policy instruments. Differences of opinion in policy debates can frequently be traced to disagreements about relevant constraints. Sections 6.3, 6.4 and 6.5 address the three core policy questions associated with the Commission's brief in this context.

While the general approach described in this paper applies to any area of structural reform, most examples are drawn from public sector pricing, taxation and social security policy. Through all of the discussion, I focus primarily on distributional adjustment costs of microeconomic reform.

In section 6.3, I discuss similarities and differences in the appropriate government response when costs of structural reform arise from government policy or from other sources. In the process, I describe how gains and losses can be traded off to evaluate the outcome for society. The constraints imposed by the nature of the structural reform are also discussed. Some examples are used to illustrate the general approach.

Section 6.4 addresses the problem of how to evaluate a policy reform in greater detail and discusses some shortcomings of other methodologies. Section 6.5 discusses some problems associated with the adjustment process and focuses on the

issue of compensation. The main conclusions to emerge from the paper are presented in section 6.6.

6.2 Setting the scene

The pace of microeconomic reform in Australia has accelerated since the early 1980s. This is evident across a range of areas.

Opportunities for improved efficiency and productivity gains have motivated many reforms. Broad-based reforms include reductions in the level of protection for Australian industries, financial deregulation and changes to industrial relations. Past income security policy focused more on providing non-means-tested universal assistance (such as for children or older people) and maintaining a fairly progressive income tax system to meet social justice aims. More recently, the focus has been on reducing the burden on public revenues by targeting assistance to the ‘needy’ using income and assets tests. Tax equity issues used to focus more on ensuring contribution according to ability to pay. In recent years, the discussion of fairness has focused on lowering marginal income tax rates to ensure ‘reward for effort’ or placing the same rate of tax on all goods so that individuals are not disadvantaged by their consumption choices. Nowhere is the change more evident than in the area of pricing policy of public sector outputs where user-pays pricing schemes (designed to meet full cost recovery or higher profit targets) are replacing tariff structures that had some equity component. Notions of ‘benefit equity’ (paying for what you get) are promoted as more appropriate than vertical equity (paying according to your means).

The focus is increasingly on competitiveness and productivity, and reducing public sector impediments to the operation of the free market. Equity is often ignored or given a very secondary role.

This approach is said to focus more on economic goals. Policy reforms are portrayed as promoting efficiency, resulting in an economy that is leaner, more competitive and more productive. On the surface many of the arguments used to motivate support for policy reforms appear quite reasonable and non-controversial.

There are obvious examples in the area of public utility pricing. Why should people not pay the full cost of the public sector outputs that they consume? If individuals benefit, should they not pay the cost of provision? To do otherwise would provide incorrect signals to consumers and would also be unfair because some users would be notionally ‘taxed’ to pay for some of the costs of supplying other users. Public sector business enterprises should be expected to return dividends to the government comparable with those of their private sector counterparts. To do

otherwise encourages inefficient resource use. Many of the policy changes reflect an adherence to fairly simple market principles. Policy decision rules tend to take the form of simple market analogues so there is little need to consider problems of economic policy case by case. Instead, public sector managers should do what a profit maximising firm in a competitive industry would do.

There is growing resistance from some parts of the community to the dominant ‘efficiency-first’ paradigm and this resistance is often viewed as economic illiteracy. This is particularly so when distributional considerations are raised. Proponents of simple market-based solutions make a claim to the ‘economic’ solution, categorising alternative views as having a ‘social’ motive that is only appropriate in a very restricted set of policy areas.

In my view many of these arguments rely on an unsophisticated economic analysis of the problems being addressed, and one that ignores advances made in the public economics literature over the last three decades. There is ample scope for criticism of the efficiency-first position from within mainstream economics. In all areas of policy development and evaluation in public economics, efficiency *and* equity should both play their part.

Correcting market failures and pricing public sector outputs using simple marginal cost rules, or targeting assistance by income tests may improve efficiency. There is no guarantee, though, that the intended efficiency gain will eventuate. Furthermore, the policy may reduce social welfare even if it succeeds in improving efficiency. Some individuals in society are likely to suffer welfare losses and if they tend to be located at the lower end of the distribution of welfare and if their losses are sufficiently large then social welfare may fall, even if efficiency is enhanced.

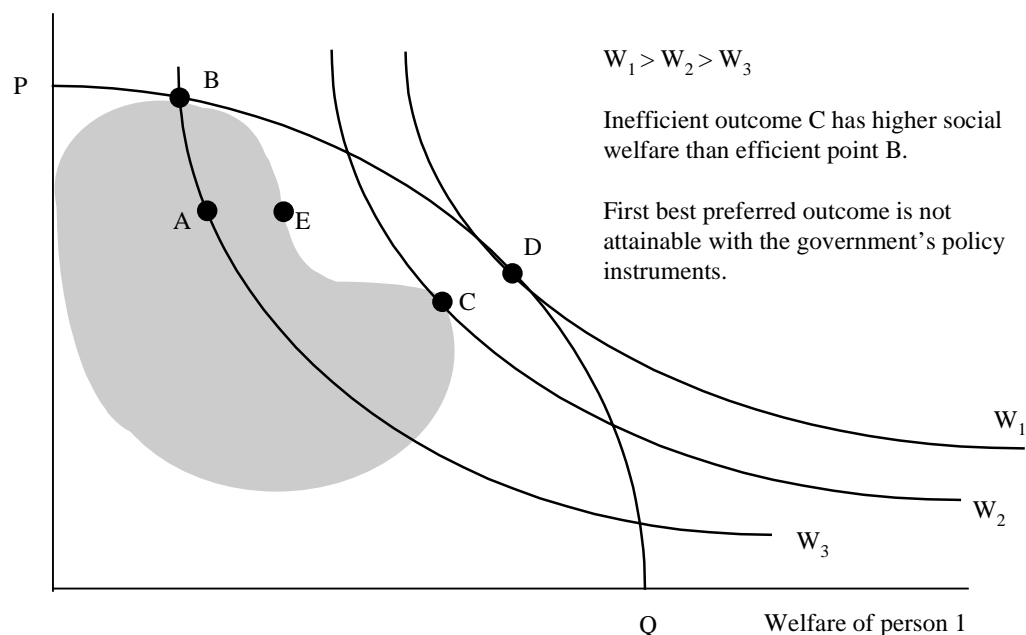
In all areas of policy, a gain in social welfare is the ultimate goal. The most important result of welfare economics is that, in a second best setting, equity and efficiency must both be addressed at the policy design stage. Efficiency and equity both matter to social welfare. This is illustrated in figure 6.1 for a simple two-person economy.

In figure 6.1, social welfare is represented by the curves labelled W , with those further from the origin representing higher social welfare. All allocations on each curve have the same social welfare. The frontier PQ represents all efficient allocations. Any allocation inside the frontier is inefficient. Assume that the free market outcome is at point A with a level of social welfare of W_3 . If all policy instruments were available to government, any efficient point on PQ is attainable. The best outcome is the one with the highest level of social welfare. This is point D . The government could move the outcome to D if it could eliminate all market failures (thereby moving to the frontier) and then redistribute between the two

individuals without imposing any efficiency cost (and staying on the frontier). This is called lump sum redistribution. It requires that no relative prices change in the process of redistributing between individuals.

Figure 6.1 **First and second best policy in a two person setting**

Welfare of person 2



Practical limitations on feasible policies prevent this. It is not possible for the government to redistribute without causing some inefficiency. When taxes alter relative prices, individuals change their behaviour, substituting between goods and activities. This substitution means that aggregate tax revenue is not sufficient to compensate for the welfare losses caused by taxation. The difference between tax revenue and the sum of the individual welfare changes is the efficiency cost of taxation.

Taxes distort behaviour so it is not possible to redistribute and remain on the efficiency frontier. When designing policies to redistribute, efficiency cannot be ignored because efficiency impacts on social welfare. When designing policies directed at correcting a market failure, equity cannot be ignored because it is not possible to correct adverse distributional outcomes without imposing efficiency costs.

Say feasible policy instruments for redistribution limit the attainable outcomes to the shaded area. In this case, the best *attainable* outcome is point C which lies

inside the frontier. C has a higher level of social welfare than point B, despite B being efficient. The government should adopt the policy reform that moves the outcome from A to C. Choosing C rather than B balances equity and efficiency goals to achieve the highest achievable social welfare. Which attainable outcome has the highest social welfare depends on the ethical position adopted.

It is not necessary to take an explicit ethical position on inequality if a policy reform simultaneously improves efficiency and reduces inequality. The move from A to E in figure 6.1 is an example of this. In this rather restricted setting, social welfare is necessarily increased if the policy is introduced. However, the aims of equity and efficiency regularly conflict and the government's role is to balance these aims to achieve the largest social gain. It is counter-productive to focus solely on either efficiency or equity.

Consider a reform that increases inequality but is claimed to be in the interests of society. For the claim to be sustained there must be evidence that the contribution to social welfare from reducing inefficiency more than offsets the social welfare loss arising from the increase in inequality. It is necessary to demonstrate this explicitly.

Advocates of microeconomic reform often make claims of enhanced efficiency without any empirical support. The strict definition of an efficient outcome is that one individual can only be made better off at the expense of at least one other person. (This is clearly so for any point on PQ in figure 6.1.) If a policy has gainers but no losers there is a gain in efficiency often termed a Pareto improvement. Social welfare also must increase. (An example of this is the move from A to E in figure 6.1.) The strict definition of efficiency involves an ethical judgement but a minimal one, namely that a policy is worth pursuing if it can make at least one person better off and no one any worse off. It is generally thought that every individual would support policies that lead to gains for some individuals without anyone losing.

Very few policies have no losers so a weakened concept of efficiency is commonly adopted — that of a *potential* Pareto improvement. This requires that the sum of gains to winners is sufficiently large to compensate (hypothetically) all losers. It is argued that policies should be introduced if the potential Pareto criterion is met. This is the standard approach of cost-benefit analysis.

This criterion represents a much stronger ethical position: a \$1 gain to any individual is given the same social value irrespective of how well off they are.

Using this notion of efficiency to evaluate policy is extremely controversial because a gain in efficiency does not necessarily imply a gain in social welfare because the

compensation necessary to eliminate losses need only be possible.⁵ A policy may reduce social welfare, despite satisfying the weakened efficiency definition, if it increases inequality sufficiently. Whether social welfare increases or decreases, depends on the pattern of gains and losses across the distribution. To determine whether such a policy is desirable, knowledge of the welfare positions of gainers and losers and an explicit ethical position on social justice is required.

Even if we consider only the weakened concept of efficiency, detailed empirical analysis is needed to determine whether gains or losses dominate. Those who argue that we should accelerate the pace of reform to promote efficient outcomes rarely provide empirical support to show efficiency gains. Instead they adopt a set of rules for judging efficiency outcomes. These rules have no basis in economics because they fail the test of relevance. They fail to provide efficiency guidelines in practical policy settings.

In fact, the rules adopted are often direct negations of well-established results in economics. They are myths rather than rules. For example, it is commonly argued that efficiency will be improved by imposing first best optimality conditions in one sector of the economy irrespective of the conditions prevailing elsewhere in the economy. This ignores research from the 1950s that shows if there is a distortion in one sector preventing the first best optimality conditions, it is generally not desirable to impose first best optimality conditions elsewhere. This is the primary result of Lipsey and Lancaster (1956) in their seminal paper on the theory of second best.

An important practical implication of second best theory is that policy development needs to take account of diversity of market structures (eg existence of sectors characterised by monopoly and competitive conditions) and interdependencies between activities in the economy (eg activities characterised by extensive opportunities for substitution such as within the energy and transport sectors).

Another myth is that an equilibrium with fewer distortions (such as fewer rates of tax or tariffs) is necessarily more efficient than one with more. Another way of saying this is that removing one of several distortions necessarily improves efficiency. This is known in public economics as the fallacy of counting distortions: removing one (or more) of a number of distortions need not improve efficiency. Efficiency depends on the size of distortions and the relationships between them and *not* on the number of distortions. None of these rules are valid yet they are

⁵ There are other problems with the potential Pareto criterion. Even in first best settings, transitivity is violated unless there is a representative consumer. Using aggregate willingness to pay also has this problem if prices are different in the two states.

commonly used to evaluate policy in a range of areas. In fact, they are often the only support provided for policy reforms.

6.3 Are policy-induced changes any different from other sources of structural change?

Welfare gains and losses caused by structural change in the economy may result from market-based changes or explicit policy changes introduced by government. The fact that the former arises from factors beyond the control of the government and the latter is the result of explicit policy means that the approach to them is inevitably rather different. Nevertheless, in either case the setting is second best, so all policy responses should be developed with social welfare gain as the focus. However, the appropriate government response and the choice of policy instruments will necessarily differ in the two cases.

In the case of non-policy-induced structural changes, it is not possible for the government to influence the distributional impacts ex-ante. Market-based changes may be consistent with a competitive market or may result from market failures that the government cannot correct.⁶ Inevitably, the government's policy response is ex post — that is, after the structural change. If the government views the distributional outcomes of the structural change as unacceptable and if it can identify policy reforms that result in social gains, then it should select the policy with the greatest forecast gain. If no social gain is possible, there should be no domestic policy response.

Consider a structural change caused by factors beyond the government's control. For example, the discovery of a resource in an overseas country may reduce demand for a local product, causing welfare losses within Australia. In this instance, a possible motivation for a domestic policy response could be concerns about adverse distributional consequences. Whether the government should respond depends on the size of any losses and where they are located across the distribution. If the losses are relatively large at low welfare levels, the government may consider it appropriate to investigate the social gains from redistribution. Whether a social gain is possible depends on the choice of redistribution instruments and the efficiency effects of the redistribution.

If adjustment costs that impact on individuals' welfare are induced by government policy, then there is scope for the government to alter the policy and mitigate

⁶ For example, the structural change may result from non-competitive behaviour in another country.

adverse impacts ex ante. Any factors that impact on welfare levels are preferably addressed at the policy design stage. Nonetheless, it may not be possible to take full account of adjustment and distribution effects ex-ante. In this case, it may be appropriate to respond ex-post as well.

Distributional impacts are a crucial input to the development of welfare improving policy reforms initiated by government. For each policy option, government should use a model of individual behaviour to estimate individual welfare gains and aggregate social gain. Options can then be ranked by estimated social gains. This information should be used to refine policy choices. Distributional effects are an integral part of policy design. If the adjustment costs are policy-induced, the government has considerably more degrees of freedom to accommodate adjustment and distributional concerns when the policy options are being evaluated. A predicted gain in social welfare must rest on evidence derived using methodologies consistent with economic paradigms and the best available, disaggregated data. The effects of the policy must be traced through to the welfare effects on individuals.

There are many examples where this procedure is not followed. Policy reforms evaluated using incorrect efficiency rules of thumb (appropriate only to first best settings) often lead to incorrect policy judgements.

Blackorby (1990) describes cases from a number of diverse areas where inappropriate first best reasoning can lead to spurious claims. He rejects the argument that the potential gains from freer trade are always positive. Apart from compensatory lump sum transfers between countries to offset losses, this conclusion rests on a number of assumptions. If there is imperfect competition, increasing returns to scale or negatively correlated risks between countries, it is possible that the free trade equilibrium is less efficient than an equilibrium with no trade. He also rejects the claims that minimum wage controls necessarily give rise to inefficiency and harm those they are designed to assist. In the presence of indirect taxes, there are circumstances where minimum wage controls can improve efficiency. In the presence of asymmetric information, in-kind transfers can be preferable to cash transfers because of self selection advantages.

Policies to promote freer trade, to remove minimum wage controls or to replace in-kind transfers with cash may not improve efficiency or social welfare. In all these cases, analysis of welfare gains and losses is necessary to determine whether the outcome is desirable. If any proposed policy change fails to promote social welfare it should be modified ex ante. It is far from best practice to introduce a policy change that may worsen efficiency and inequality and then to seek to address some adverse impacts ex post.

This is true in all policy areas. Two examples covering reform to water pricing and the taxation of leaded petrol are set out in box 6.1 to illustrate how policy should be modified at the design stage to address possible policy-induced costs. Box 6.2 illustrates how equity issues are addressed in tax design.

Box 6.1 Modifying reform to lessen adverse side effects

Water pricing reform

In the pricing of essential services, like water, the simple efficiency rule is to set the price or usage charge equal to short run marginal cost (SRMC) as this gives consumers the correct price signal in relation to the cost of supply. However, because of the natural monopoly nature of the industry (high fixed costs and low variable costs), average costs are higher than SRMC — pricing at SRMC will result in the utility incurring a loss.

There are a number of options for recovering the loss. The government, by raising general taxes (with the associated deadweight efficiency cost), could offset the loss with an operating subsidy. Alternatively, a two-part tariff could be applied — this would involve charging users the marginal cost of supply but also an access charge to cover fixed costs. Provided that no consumer disconnects from the service, the access charge has no deadweight efficiency cost and merely redistributes consumer surplus from consumers to the utility. It is, in effect, a lump sum or poll tax.

However, this focus on efficiency rests on the first-best assumption that adverse distributional effects can be fixed without any inefficiency by using lump sum redistribution. This is not the case. The appropriate user pays pricing structure for public sector outputs in a second best setting requires that equity and efficiency be addressed simultaneously.

A two-part tariff can be applied in such a way as to simultaneously balance equity and efficiency concerns. One approach involves setting the usage charge equal to SRMC thus providing correct price signals to water consumers but modifying the access charge to reflect consumers ability to pay. If data on income is available, it could be used as an indicator of well-being; if not, some surrogate which is positively correlated with consumer welfare may be used to set the access charge. In this way, non-usage related costs are covered less regressively, so that revenues are raised in a manner more in accord with society's concern for distributive justice (Brown and Sibley 1986).

Another way to balance social justice and efficiency that is less efficient, is to lower the regressive access charge and meet the revenue requirement by increasing the user charge above SRMC. This achieves an equity gain if usage of the service is positively correlated with well being (Feldstein 1972). This may involve cross-subsidies between different sub-markets of customers such as residential, commercial or industrial users but these cross subsidies are an appropriate response.

(Continued next page)

Box 6.1 (Continued)

As observed by Quiggin (1997) redistribution through the adoption of such a pricing structure can be efficiently pursued while ever the resulting cost of redistributing remains below that of the efficiency cost of pursuing redistribution through the tax-welfare system.

Leaded Fuel Tax

The simple efficient solution to a consumption externality is a tax on the polluting commodity — in this case, leaded fuel. The higher price of leaded fuel reflects the social cost of lead pollution, and gives incentives for consumers to use fuel in an environmentally responsible manner.

The theory of optimal pollution taxes focuses on the allocative efficiency of markets to include environmental costs, and rarely, if ever, concerns itself with its associated undesirable distributional consequences, as these are implicitly assumed to be corrected through personalised redistributive taxes.

Most fuel taxes are likely to be regressive since fuel is a necessity, implying that those on lower incomes spend a higher proportion of their income on fuel. Also, a leaded fuel tax will impact upon those consumers who own cars which run on leaded fuel and these consumers are more likely to be earning lower incomes and hence are unable to purchase newer and more expensive vehicles which are powered by unleaded fuel. Finally, such a tax will raise the price of fuel to producers, thus increasing the price of a wide range of final goods and services which may impact regressively.

One way of dealing with these adverse distributional effects would be to implement some sort of access charge for leaded fuel use (such as through car registrations). However, modifying this charge for redistributive justice may lead to some difficulties, particularly if registration costs significantly affect the demand for older, lead emitting vehicles.

Alternatively, the tax rate paid on leaded fuel could be modified so that it is based on ability to pay. For example, subject to available information, the tax rate could be varied across households depending on income and consumption patterns. Such a pricing scheme would be informationally demanding — information would be needed on society's 'inequality-aversion' and a proxy for ability to pay, but this information is required under any scheme of income redistribution.

Source: Savage and Hart (1995).

Box 6.2 Addressing equity in tax design

In the discussion of tax reform it is commonly argued that efficiency requires placing the same rate of tax on all goods and that any adverse distributional consequences should be addressed by compensation. This is inconsistent with both the theoretical and empirical tax literature. If there are any goods or services excluded from the tax base, then efficiency requires varying rates of tax set to bring about the same proportional reduction in demand for all taxed goods and services. When all tax revenue is raised from a consumption tax, the optimal tax structure involves different tax rates on different goods and services. Tax rates should be set to achieve larger reductions in demand for goods that form a larger proportion of the expenditure of rich households with smaller reductions for goods forming a larger proportion of expenditure of poor households.

When all tax revenue is raised from a linear income tax, the equity consideration depends on the relationship between the tax base and the social value attached to a gain. The efficiency impact depends upon labour supply effects, in particular the compensated labour supply elasticities.

When income taxes are combined with consumption taxes, the optimal indirect tax depends upon the kind of income tax in place. In general, the consumption tax rate imposed on a good depends on the target percentage reduction in demand. This, in turn, depends upon the distributional characteristic of the good, which is determined by the pattern of consumption across the distribution and the ethical judgement on inequality.

In the presence of an income tax, the optimal set of consumption taxes imposes the different rates of tax. If the income tax is fairly inflexible (such as a flat tax with a uniform threshold or lump sum transfer), the motivation for the consumption tax is to increase tax progressivity and reduce inequality. Consumption tax rates should be varied to lower the proportional burden on low wage individuals. Higher rates of tax should be placed on goods consumed proportionally more by high wage individuals.

Regressive indirect taxes (such as taxes on food and public sector services) can be imposed but only if the revenue is used to increase a universal transfer payment. This is justified because low income groups receive more of the revenue than they contribute. Otherwise taxing necessities is undesirable. The case for a flat rate consumption tax is made even weaker if the progressive nature of the income tax system is eroded. Shortcomings of the income tax justify a more progressive consumption tax but not a regressive one.

6.4 Evaluating policy reforms — the how and why

In economics it is typically assumed that each individual is the best judge of his or her own well being. Decisions about the allocation of time to activities and the allocation of income to investment and consumption are made with the aim of achieving the highest level of satisfaction attainable with the available endowments of time and other assets.

To evaluate microeconomic policy, we first need a framework for ranking outcomes that impact on the welfare of individuals. This involves making value judgements in order to answer ethical questions. We also need to model how people behave. This is essentially a descriptive or positive task.

Welfare economics addresses how society ought to be arranged, conditional on data, behaviour and ethical values. It identifies the areas of economic activity where government has a legitimate microeconomic policy role. These relate to adverse market outcomes due either to market failure or a socially unacceptable distribution of resources.

6.4.1 The evaluation framework

In public economics the government's goal is to maximise the social welfare of the community. Social welfare does not refer only to safety net policies for those with low income. It is defined more broadly as the aggregation of the living standards (not incomes) of *all* members in society.

The impact of policy on social welfare is considered via two dimensions: equity and efficiency. The equity implications depend on the pattern of gains and losses across the whole population. At the same level of aggregate welfare, social welfare is increased if inequality is reduced. Efficiency is necessarily enhanced if a policy change brings about a gain in living standards for some with no losses to any other group (a Pareto improvement). In the more general case when policy entails winners and losers, the efficiency impact is determined by the sum of gains and losses (a potential Pareto improvement). If total gains exceed losses there is an efficiency gain and vice versa. The central question in relation to efficiency is whether it is *possible* for gainers to compensate losers (a *potential* Pareto improvement).

An efficiency gain indicates that the total 'welfare cake' to be distributed to individuals has been increased and that it would, in principle, be possible to redistribute gains so that no-one lost. It is important to note that the compensation is hypothetical; there are still losers but the *possibility* of eliminating losses by redistribution exists. If there is an efficiency gain, social welfare is *potentially*

increased. Whether this constitutes an *actual* improvement for society depends upon the *distribution and size* of actual, not hypothetical, individual gains and losses in living standards.

The process of evaluating policy necessarily involves treating people differently depending on where they are located in the distribution of welfare. This is true whether the policy is a response to structural changes beyond the control of government or at the policy design and evaluation stage of policy-induced welfare changes.

The fundamental ethical question is how to translate the gains and losses of individuals located across the distribution of well-being in society into a social gain. The formal mechanism for this is the specification of a social welfare function, which links the well being of all individuals in society to a level of aggregate social welfare. The way individual welfare is aggregated into social welfare depends on ethical judgements concerning the distribution of welfare.

Welfare economics identifies two desirable characteristics of a social welfare function based on assessments of individual welfare — anonymity and the principle of transfers. Anonymity requires that social welfare depend only on the distribution of well being of individuals in society and not non-welfare characteristics. Anonymity is contravened if some individuals are given priority or receive lower status in social evaluation because of characteristics such as age, gender or ethnicity. Who an individual is or what non-welfare attributes (such as sex or age or ethnicity) they possess should not matter for social welfare. The other desirable characteristic is called the principle of transfers. It says that a transfer that redistributes from someone better off to someone less well off should increase social welfare. How much social welfare is increased by such redistribution requires a specific ethical judgement on the extent of aversion to inequality.

The extent of aversion to inequality in society determines the relative weights placed on the gains and losses of individuals placed differently in the welfare ordering. This means that the impact on social welfare from a policy change depends on the pattern of gains and losses as well as their sum. I illustrate this using the most commonly adopted general form of a social welfare function that builds in these principles and makes the ethical position explicit namely:

$$W = \frac{1}{1-\nu} \sum U_i^{1-\nu}$$

This says that social welfare depends on the weighted sum of individual welfare raised to a specific power. The ethical position is represented by the value of ν . This value specifies the weightings given to gains and losses across individuals.

One extreme ethical position sets ν to zero. At this value, gains and losses are weighted equally irrespective of individual welfare levels. As ν increases the ‘dislike’ or aversion to inequality becomes stronger.

Say we have two individuals with person 1 twice as well off as person 2. The trade-off between the welfare gains of the two individuals is given by:

$$\left(\frac{U_2}{U_1}\right)^\nu = 2^\nu$$

A small degree of aversion to inequality ($\nu = 1.5$) implies that the weight on a welfare gain of person 1 is 2.8 times that placed on a welfare gain of person 2. A moderate degree of aversion to inequality ($\nu = 3$) implies that the weight on a welfare gain of person 1 is 8 times that placed on a welfare gain of person 2.

These tradeoffs can be implemented in a straightforward manner. The appropriate weights must depend on the welfare levels of winners and losers.

Whether governments have a microeconomic policy role depends upon whether markets, free of intervention, can achieve the desired social welfare maximum. It is well recognised that there is no automatic mechanism working towards a socially just outcome, so that the free market outcome is unlikely to be equitable. This indicates a *prima facie* case for government intervention to ensure desirable distributional outcomes.

One of the two major results of welfare economics states that any desired market outcome (such as a socially just one) can be consistent with efficiency provided the government makes the appropriate set of redistributions. The crucial assumption here is that redistribution cause *no efficiency losses*. The only taxes which achieve this are called lump sum taxes, taxes that cause no behavioural changes because whatever action individuals choose, they face the same tax burden. (Examples of lump sum taxes are poll or head taxes, or taxes based on height or eye colour or some other attribute over which individuals have no control.) Such taxes are inconsistent with equity goals and are not generally feasible in practice. If, as a society, we consider the distributional outcome free of government action as unacceptable, and we desire to achieve a more equitable outcome, then we are limited in practical second best settings to a menu of taxes/charges which distort behaviour and so cause efficiency losses. There is inevitably an equity-efficiency trade-off that cannot be avoided so it is not possible to separate equity and efficiency when designing distributional policy. Of course, efficiency losses of different taxes/charges vary, so in practice, we are likely to be interested in the relative efficiency of different redistributive measures.

The efficiency dimension is rather different. Since the time of Adam Smith, economists have argued that (where markets are well behaved) there is an automatic mechanism guiding the market solution towards an efficient outcome. This is the other major result of welfare economics. Market prices work like an ‘invisible hand’ co-ordinating the self-interested decisions of individual consumers and producers to produce an efficient allocation. This is the basis of the general support by most economists for market-like solutions. When markets work well they should be let do their job. However, real world markets, as opposed to theoretical ones, often fail. Where this occurs, market prices provide incorrect signals for guiding individual decisions. There is then a prima facie case for government intervention to improve efficiency.

The conditions required for an efficient set of free markets are that all individuals and coalitions of individuals have no power to set prices; there are no externalities impacting directly on firm outputs or individual utilities, there are no public goods; and information is complete and symmetric.

When those training as economists are introduced to the question of microeconomic policy intervention by governments, the process begins simply: by considering one problem at a time, despite the fact that in practice problems of distribution and market failure tend to occur simultaneously. If first best simplifying assumptions allowing the focus on a single issue are imposed, it is not surprising that the resulting policy decision rules become quite simple. The notion that individual market failures can be addressed by individual policies, treating them in isolation, is referred to as piecemeal reform or a first best policy approach. If the underlying assumptions were met, this approach would be welfare improving. However, one of the most important results of the economics of the second best is that piecemeal application of first best policies cannot be guaranteed to improve social welfare. It has frequently also been shown to lead to inefficient outcomes.

One particularly relevant issue in this context is whether issues of equity and efficiency can be separated. In considering distributional matters a first best approach assumes that there are no market failures and, as well, that redistribution can be achieved without imposing any efficiency costs on the economy. Similarly, in considering the appropriate responses to any one market failure, a first best approach assumes that the distribution of real income is optimal, so that any revenue required may be raised with no efficiency impacts and without disturbing the optimal distribution. Under such circumstances, appropriate policies often take the form of market analogues. For example, the appropriate response to natural monopoly is to ensure that the enterprise charge a price for output equal to (short run) marginal cost, as would a profit maximising firm in a competitive market. If

there is a negative externality, the government effectively creates a surrogate market for the externality, charging a tax equal to the marginal cost of the externality.

Realistic constraints in practical policy settings are ignored in these simple decision rules. For example, the price equal to marginal cost solution for the natural monopoly will cause the monopoly to make a loss. The first best assumptions imply that this loss will be met out of government tax revenues which, it is assumed, are raised without imposing any efficiency cost on the economy. Furthermore, it is assumed that income distribution is optimal. Once we reject these unrealistic assumptions and consider second best policy, we find simple price equals marginal cost solutions are no longer the appropriate decision rules for maximising social welfare. Once more realistic constraints are taken into account issues of equity and efficiency cannot be separated.

Disagreements on desirable reforms persist partly because the first best approach generates policy rules of thumb which are very simple and familiar. In contrast, the more sophisticated and relevant second best approach generates decision rules which are more complex and are often quite distant from familiar market analogues.

6.4.2 The behavioural model

If a policy is to be evaluated at all, welfare gains and losses have to be estimated. This is true *in all circumstances*. For example, to identify the *main* gainers and losers, it is necessary to estimate the gains and losses for *all* individuals and to determine where the main gainers and losers are located across the distribution of welfare. To determine whether efficiency is likely to be enhanced, it is necessary to determine the sign of the sum of individual gains and losses. To determine social welfare gains or losses, it is necessary to determine the sign of the weighted sum of individual gains and losses, where the weights depend on the position of each individual in the distribution of welfare and the ethical position on inequality.

How is this to be done?

Attempts to model reforms in a manner consistent with underlying economic theory are based on rational optimising behaviour since this is the basis of economists' evaluative tool. Essentially, the aim is to integrate behaviour with the evaluation of welfare changes.

The goal of policy reform is to increase social welfare represented by an explicit social welfare function defined on cardinally comparable utility levels. Individuals are assumed to maximise utility subject to the budget constraint defined by the

individual-specific set of prices, wage rates and endowments. Private income is derived from individuals' endowments of income generating assets such as time, housing and other investments. They make choices such as how much time to devote to work, how to allocate their earnings between consumption and savings, how much to consume over their lifetime and how much to bequeath. The choices available to them determine their welfare level.⁷

In the most general approach, current and future good consumption and labour supplies are treated as endogenous choices. These are altered by policy parameters, such as tax rates. Various assumptions can be made about the structure of preferences involved in the model. Empirical tax modelling using microdata begins with detailed information concerning the distribution of budget parameters. This data is used to estimate a set of utility consistent Marshallian demands.⁸ The specification of preferences must be sufficiently flexible to capture the behavioural responses and cross effects inherent in the data set on which the model is estimated. Commonly used simple functional forms (such as the linear expenditure system or the constant elasticity of substitution specification) are too restrictive for tax analysis.⁹

The parameters of the estimated demand system are also the parameters of the underlying utility function. The estimated system thus allows welfare ordering of households to be determined.¹⁰ It is convenient to present the welfare levels in money units for ease of interpretation.¹¹ Equivalent income is a money measure of utility requiring the use of constant reference prices across households. It is the level of income which yields the pre-reform utility level, were the individual faces a hypothetical set of reference prices and reference household structure.¹² Individual

⁷ Ideally the government's equity objectives should be based on the goal of redistributing between individuals on the basis of lifetime utility. However, there are serious data difficulties in implementing a lifetime approach to the assessment of equity. The difficulty in obtaining satisfactory information means that the assessment of equity is necessarily tied strongly to cross section data.

⁸ An acceptable, but less reliable approach is to calibrate a behavioural model using parameter estimates from the empirical literature.

⁹ A model that implicitly fixes labour supply or restricts the range of elasticity responses is not likely to estimate revenue changes very well nor is it likely to answer important questions concerning changes in behaviour such as labour force participation or savings behaviour.

¹⁰ For an application to the measurement of inequality see Apps and Savage (1989).

¹¹ In addition money metric utility is unique irrespective of positive monotonic transformations.

¹² There are some problems that need to be addressed when using money metric utility. It is generally not concave for all choices of reference prices. If the social aggregator is defined on money metric utility alone, the informational basis implied by the form of the monotonic transformation (which depends on the indirect utility function) places restrictions on the social aggregator that can be used (see Roberts 1980). The social aggregator may, however, be modified

well being depends on the *options* open to people and the prices they face, and not just the *choices* they make.

Once the welfare ordering has been determined, the behavioural model can be used to simulate a policy reform. Price changes generate different choices and result in changes in utility. Different aspects of a policy reform result in particular relative price changes. The welfare impact for each individual depends on the resulting set of relative price movements. This means that it is best to model the various aspects of the policy together if they simultaneously impact on prices.

The change in welfare is measured by the equivalent gain (see King 1983).¹³ This measure is consistent with the utility maximisation paradigm. The equivalent gain resulting from some reform-induced change in prices and income, is defined as the increment to pre-reform (full) income required to achieve the post-reform utility level. Equivalent gains are calculated for each agent.

Equivalent gains are used to calculate the aggregate efficiency impact and the social welfare implications of the reform for a range of aversions to inequality.

For a budget neutral reform, the impact on efficiency is given by the sum of equivalent gains. This is a potential Pareto measure of the change in efficiency. If net gains are positive, gainers could hypothetically compensate losers. Were this compensation to be paid (without causing any relative price effect) there would only be gainers and social welfare would necessarily increase. The amount of the increase in social welfare would then depend on the weights attached to the individual gains after compensation. If the compensation remains hypothetical, a gain in efficiency does not necessarily imply a social gain. The social gain depends on the weighted sum of welfare gains before compensation. Whether a policy increases social welfare depends on the pattern of gains and losses across the distribution and hence the weights attached to individual gains and losses.

There is no justification for placing a higher weight on losers than gainers. Relative weights should be determined, not by whether an individual gains or loses, but by their relative welfare levels.

to return the same ordering (see Blackorby and Donaldson 1988). If household characteristics are used, it is generally only possible to retrieve the cost function which is conditional on household characteristics. This means that the direct and positive welfare effects of children may be overlooked. One way around this is to impose the restriction that equivalence scales are independent of the base level of utility variation (see Blundell and Lewbel 1991; Lewbel 1989; Pollak and Wales 1979).

¹³ One might resort to non-utility-maximising estimates of welfare change such as the Laspeyres measure but these measures are not exact and do not allow measures of the efficiency impact of a policy.

There is no theory in public economics supporting the view that the impacts on regions and industries should be considered independently of the welfare gains and losses of individuals who live and work in them unless there is some regional externality. Regions could be given priority by placing a higher weight on the gains and losses of individuals living there than those in other regions with equal welfare. This would contravene the anonymity principle of social welfare functions, which is a standard assumption accepted in public economics. To give priority to certain regions or industries introduces political judgements that are not part of the accepted methodology of public economics.

If, however, losses are concentrated in regions where individuals tend to have low welfare levels compared with the average, the standard methodology, which balances equity and efficiency, addresses this.

The aggregate welfare gains of individuals in particular industries and regions can be investigated using information developed in the standard methodology (provided the region is not suppressed in the data for privacy reasons). If losses are concentrated in a region and welfare levels tend to be low as well, the region may provide an additional instrument for modification of the policy to increase social gains. If there are externalities, which have a spatial or industry dimension, then the welfare impact of these should be built into the standard methodology.

The results of economic modelling undertaken in the welfare economic, rather than macroeconomic, tradition estimate both efficiency gains and social gains in comparable units (dollars). If a policy is predicted to enhance efficiency and reduce inequality, then it is clearly a desirable reform. Often efficiency and equity outcomes conflict. Whether the policy results in a social gain can only be ascertained by modelling the welfare impacts of the policy and balancing the conflicting goals using an explicit ethical position to trade off gains and losses. Making this judgement explicit determines how ‘demonstrably large’ efficiency gains need to be to result in a social gain when a policy has adverse distributional outcomes.

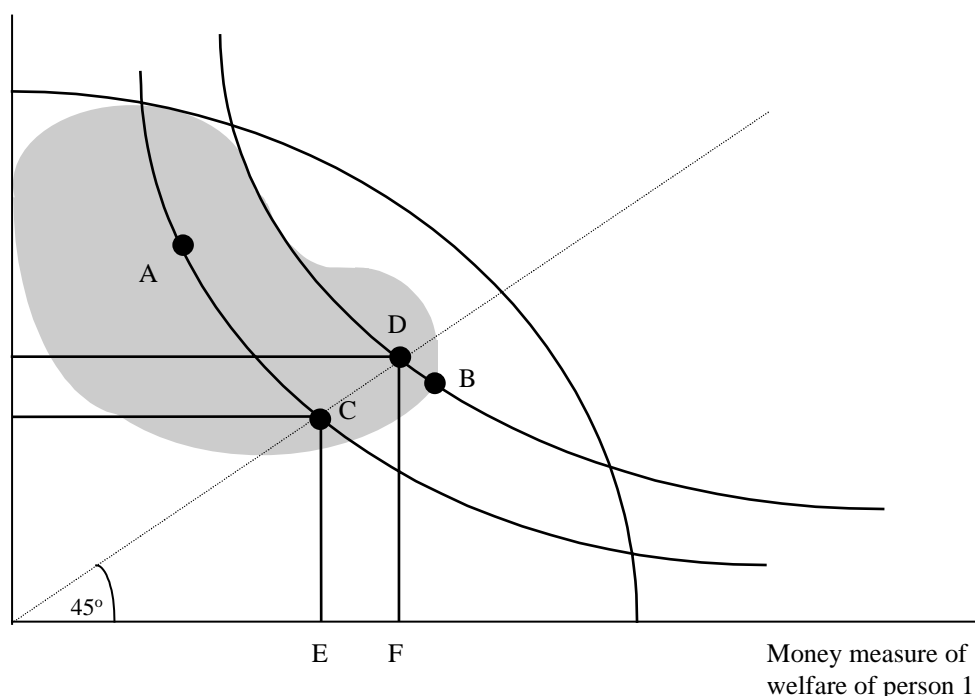
Once the welfare gain of each individual is determined the social gain of a policy reform can be derived. This will depend on welfare levels of gainers and losers, the size of gains and losses and the ethical position taken regarding inequality.

One way of doing this is to determine the uniform income transfer (positive or negative) which results in the same change to social welfare as the policy. This is shown diagrammatically in figure 6.2 for the simple case of a two-person economy. The status quo is represented by the distribution of welfare at point A. The same level of social welfare is achieved at C where the two individuals have equal welfare. The policy reform moves the outcome to B. It can be seen that social

welfare is enhanced. The higher level of social welfare can also be attained with equal welfares for person 1 and 2 at point D. The distance EF is the social gain of the policy.

Figure 6.2 **The social gain of a policy reform in a two person setting**

Money measure of welfare of person 2



The social gain is the equally distributed increment to income needed to achieve the post reform level of social welfare. Clearly, the social gain depends on the curvature of the social welfare contours. The higher the inequality aversion, the more curved the social welfare contours and the greater the social gain of a policy that reduces inequality.

This approach allows the sensitivity of outcomes to ethical judgements to be investigated. For example, a policy may result in positive aggregate net gains but, at the preferred ethical position, may be a social loss because there is a tendency for those at low welfare levels to lose and those at high welfare levels to gain. In this circumstance, we can determine how small the aversion to inequality would need to be to turn the social loss into a social gain.

If the level of inequality aversion is greater than zero, equity and efficiency considerations are traded off. At very low levels of inequality aversion, efficiency concerns dominate. At very high levels of inequality aversion, the welfare impacts

of individuals at the bottom of the welfare distribution dominate. The effect of moderate levels of inequality aversion ($\nu = 1.5$ to 2) is to take greater account of the welfare effects on those individuals towards the middle of the distribution. Because the level of inequality aversion determines how the gains of individuals at different welfare levels are traded off, there is no straightforward way of placing equal weight on equity and efficiency.

When policy options are evaluated the process should be forward-looking. Each option should be simulated to assess the welfare impacts. Unless this procedure is adopted, nothing can be concluded about efficiency and there is no behavioural basis for determining the welfare ordering and household welfare gains.

The preceding discussion outlines the ideal framework for assessing the efficiency and social welfare implications of potential policy changes. In the real world, data and other practical constraints may preclude such a comprehensive analysis. Nevertheless, current data sets and analytical techniques do not preclude some examination of distributional impacts. In drawing on these approaches, it is, however, desirable to have regard to a number of guidelines to ensure a reliable analysis (with suitable adaptations depending on the nature of the policy change being examined):

- Wherever it is available, data on actual (not hypothetical or cameo) households/firms should be used;
- The impact on households of different compositions (eg number of adults, number of dependent children) should be presented separately;
- Full income rather than earned income would be preferable for ranking households as it gives a more reliable measure of a household's options;
- If households are ranked by their earned incomes, those with different labour market attachments should be analysed separately as well (ie two full-time earners, one full-time and one part-time etc);
- The best disaggregated household data on activities and consumption should be used;
- The assumptions underlying the calculation of relative price effects of the policy should be made explicit; and
- Where the results are likely to be sensitive to changes in key variables, this should also be made explicit through techniques such as sensitivity analysis.

How should social gains not be determined?

In contrast to the procedure outlined above, the efficiency impacts of a policy and the distributional impacts are typically addressed separately.

Much of the modelling of distributional effects avoid making any explicit assumptions about the underlying preference structure and proceeds as if income and utility were synonymous. The welfare ranking is typically based on gross income, which may be adjusted using some equivalence scale. Gross income provides a utility metric only if substitution is ruled out (but then efficiency gains are zero).¹⁴

What factors determine living standards? The general perception is that living standards are determined solely by how much money a person or family has. This perception is a major problem because it ignores the value of activities outside of traditional markets. In addition to the goods and services which can be purchased with earned income, work in the home contributes to the well-being of families as does the amount of time available for rest and recreation (leisure time). The value of time out of the labour market, whether spent as leisure or to produce goods and services at home, is the most significant omission when observed income is used to measure ability to pay. It poses a particular problem for comparing the welfare of households since there is greater scope for varying time commitments to market work.

Consider two otherwise identical households, one with one-earner and one with two-earners. In the first, the husband earns \$50 000 annually, for full-time work of 40 hours per week. In the second, the husband earns \$30 000 and the wife \$20 000, both working full-time. The first household is clearly better off because it has a larger set of opportunities (and hence more choice). It needs to work only half the time to earn its \$50 000 leaving an extra 40 hours per week for home production or additional leisure activities. The use of household income reorders households; one effect is to overstate the well-being of two earner households.

Welfare change is typically measured by the change in the cost of the pre-reform choice, ignoring any substitution effects arising from the policy. Policy regimes are

¹⁴ Only when goods are consumed in fixed proportions are the commonly adopted measures of welfare and welfare change consistent with utility maximisation. Given that this kind of behaviour is unlikely to be very useful in generating observed data, perhaps welfare measures implicitly based on this premise need stronger justification than the usual defence that they provide a snapshot view. An extremely important focus for the analysis of policy reforms is the impact on efficiency. If substitution is ruled out efficiency costs are necessarily zero. This limits the discussion of reform to a 'snapshot' of the distributional impact alone.

often compared which are not budget neutral. In a comparison of tax systems, this unfairly biases the analysis against the policy regime with the higher tax revenue.

Often hypothetical households or cameos are used and the analysis is not linked to actual individuals or households. This seriously distorts the analysis because the use of averages commonly conceals important welfare impacts. Welfare gains should use each household's earnings structure, demographic make-up and expenditure pattern. When the systems being compared are not budget neutral, the analysis overstates the benefits of the system with smaller budget.

While it is generally the case that distributional analyses ignore behavioural changes, it is very surprising that the efficiency case for structural reforms often relies on first best arguments without empirical support. The efficiency impact of a policy cannot be judged using inappropriate efficiency rules. It is not possible to calculate the potential Pareto improvement from a policy reform without estimates of welfare gains and losses across the community.

Another approach to the calculation of efficiency impacts uses Harberger triangle, partial equilibrium approximation.¹⁵ This method of approximating the welfare effects of a tax should only be applied to the Hicksian demand function, but a common practice is to apply the same procedure to the Marshallian demand function. A linear approximation for the demand function is adopted. While there is likely to be a distortion associated with using a linearised approximation of the market demand curve to approximate the sum of welfare changes, there is a greater problem when the approach is used to calculate the efficiency costs of a differential rate of tax on a particular good or service. This is because the partial equilibrium approach fails to take into account exclusions and untaxed items.

In summary, efficiency impacts must be based on a disaggregated assessment of welfare impacts. There is no case for allowing policy reforms, which have clearly demonstrated efficiency benefits, to proceed and deal with any adverse equity impacts separately through generally available welfare measures. Equity and efficiency must be addressed simultaneously when policy options are ranked (see box 6.3).

Reforms move the economy from one inefficient equilibrium to another. There is no way to know the efficiency or social welfare impacts of a policy reform without detailed modelling of the welfare impacts. In second best settings, the removal of any one distortion (such as a tariff) may not improve efficiency or social welfare. The onus of proof should always rest with the advocates of reform. This is fundamentally an issue of transparency. Those advocating a policy reform must

¹⁵ See, for example, Freebairn (1997) and Albon (1998).

view the outcome for society as positive. There is no reason that the empirical analysis demonstrating social gains should not be shared with the community. The community has the right to know the overall social gain predicted to flow from a policy reform and how gains are distributed across the population.

Box 6.3 Balancing efficiency and equity — some key considerations

Since the government's economic instruments do not include personalised lump sum taxes to achieve distributional goals, in all areas of policy there is a requirement to balance equity and efficiency in the pursuit of welfare gains.

Nevertheless, a number of arguments are often advanced for ignoring equity issues. Let's review them briefly. An ideological mistrust of government intervention in the marketplace certainly plays a role. Libertarian philosophy questions the need to consider distributive equity at all, particularly if it induces policies that infringe upon civil liberties. 'Public choice' theories argue against intervention by emphasising the presence of 'government failures'. Because governments are prone to a number of inefficiencies, their interference with the market mechanism should be minimised particularly if the aim is to promote distributive equity. Beyond this, it is often maintained that economic 'tools' for analysing the allocative efficiency of various policies are much more effective than those available to consider distributional issues. Accordingly, until distributive 'tools' reach greater levels of sophistication, the economist should concentrate on the 'real' issue: allocative efficiency. Finally, and supposedly most damningly, the economist who tries to consider distributive equity is often accused of 'unscientifically' injecting their own value judgements into the analysis.

The latter two arguments against considering distributive equity are particularly weak. Advances in the theory concerning determination and measurement of income inequalities are many, and have made the study of distributive equity infinitely more tractable. The message for the economist is clear — sophisticated tools analysing the equity effects of various policies already exist. To ignore these tools would not only put the economist under the risk of being labelled 'insensitive', but, as second best theory so often points out, also threatens the validity of the efficiency results obtained. To claim that it is not the economist's job to consider distributive equity is not only weak, but a contradiction in the extreme since ethical judgements are not avoided by focusing on efficiency alone. In short, not considering distributive equity because of a fear of imputed 'value judgements' is, in Baumol's words 'indefensible' and suggests a basic ignorance of the fundamentals of second best economics.

Source: Savage and Hart (1995).

The Governments' tax reform proposals can be used to give these criticisms more substance. The tax reforms proposed by the government are not modelled according to accepted procedures in public economics. The overview of the paper indicates

that the ‘inequities, inefficiencies and unfairness of the current system’ are the factors motivating tax reform (Treasurer 1998, p 3).

Despite this, there is no analysis of efficiency. There is also no empirical support for the claim that the single rate GST is more efficient than the multiple rate structure of existing indirect taxes. Instead the efficiency claims rest on the fallacy of counting distortions. The number of different rates of tax has no necessary link to efficiency. No case is demonstrated for an efficiency gain over the existing system. It is assumed that income tax cuts will improve the incentive to work. However, the labour supply decision depends on the real wage and no account is taken of the reduced incentive to work arising from the GST. A substantial percentage of the population would face higher real, effective marginal tax rates due to increased consumption tax rates on some goods and changes to the targeting of pensions and transfers.

The only way to compare the efficiency merits of the status quo and the proposed system is to sum the welfare gain of each household taking into account the behavioural responses to relative price changes flowing from the reform. This has not been done.

The analysis of distributional effects undertaken by the Treasury and the subsequent analysis for the Senate Committee by Warren et al (1999) calculate increases in the cost of living associated with the package for a set of cameo (hypothetical) households at varying income levels. The cameos represent only a subset of households and the welfare impacts are distorted by the use of average CPI effects (just one for the treasury analysis and one for each cameo in the Warren et al analysis). Both fail to model the welfare gains of actual households.

The Treasury analysis is based on a number of assumptions that bias the results because they are inconsistent with observed behaviour (notably, zero saving out of disposable income and the same consumption pattern for all households). The impact on the cost of living has also been criticised. Major shifts in behaviour are also likely to result from the substantial changes to relative prices that the proposal would introduce. These are also ignored when ‘benefits’ are calculated.

To compare the status quo with the proposed tax system, both systems should be budget neutral. Otherwise there is a bias in favour of the tax system with the smaller public sector unless the welfare impacts of this are traced through to welfare changes. This is not done for the proposed tax reform.

Even if all these methodological problems are ignored, the analysis does not represent a valid distributional analysis because it fails to illustrate *the pattern of gains across the actual distribution of households* in the community. To make a

distributional judgement it is necessary to determine where gains are concentrated. If the tax and family assistance changes are modelled using data on actual households (but without behavioural responses) there is clear evidence that the tax reform would increase inequality substantially. This is both because the GST is by itself more regressive than the existing Wholesale Sales Tax system (predominantly because of the inclusion of food in the base) and because the large tax cuts that it makes possible are directed to the very top of the income distribution.

Claims that a microeconomic reform promotes the national interest should rest on sound economic support.

6.5 Handling the adjustment process associated with reform

If adjustment costs and distributional consequences of reform are addressed at the policy evaluation and design stage (by balancing equity and efficiency), there will be little need subsequently to address adverse welfare impacts.

What do we mean when we talk about compensation in the context of policy-induced change? In general, the social security system provides one way of addressing many of the transitional costs associated with the process of adjustment. Compensatory measures are typically seen as involving assistance beyond the social security system. However, what is and is not compensation is often unclear. For example, in the Government's proposed tax changes, increases in the level of pensions are generally regarded as compensation for the GST, whereas if part of the compensation were replaced by the zero-rating on food, it is unlikely that the treatment of food would be classified as compensation. Are tax cuts of \$90 per week to high income individuals a form of (over-) compensation for the GST? Is the zero-rating of aspects of health and education compensation or an integral part of the tax reform package?

There are a variety of approaches which can be adopted to better handle adjustment and distributive issues associated with reform. These are briefly discussed below.

Modifying policy — a form of compensation?

As noted in section 6.3, if any proposed policy change fails to promote social welfare it should be modified *ex ante*. There is a strong case for modifying a proposed policy change where the expected gains are concentrated at high welfare levels and the losses at low welfare levels. Social welfare is likely to be higher if a

policy is modified ex ante than if some form of compensation is used to redress adverse impacts ex post.

How a reform should be modified to take account of the social losses flowing from adverse distributional impacts depends on the particular policy (see box 6.1 for proposed policy modifications for water pricing and leaded fuel taxes). In all policy settings, the modification should be chosen to achieve the greatest gain in social welfare.

There are no general answers to how this should be done. In some policy settings there are more degrees of freedom than in others. In some cases (such as pricing reform for infrastructure services) it may be possible to improve outcomes by a narrow modification to proposed new pricing structures, in other cases the response may need to be broader (for example, addressing unfavourable distributional impacts of the proposed tax reform package may require zero-rating key necessities within the GST tax base and reducing the generosity of tax cuts to high earners).

Policy options must be modelled on a case-by-case basis and then ranked. The impacts of each policy can be simulated assuming no other changes in the economy using an estimated (or calibrated) behavioural model. Modelling the disincentive effects of price changes is a standard part of this procedure. The preferred methodology is outlined in section 6.4. If the government does not have access to a utility-consistent, disaggregated model of behaviour, no efficiency analysis can be undertaken and the distributional analysis should follow the guidelines outlined in section 6.4.

Broad-based reform — a form of compensation?

A broad-based approach to reform could play a role in reducing adjustment problems and providing a better overall distributional outcome. For example, combining reforms directed at trade liberalisation with complementary reforms to the delivery of infrastructure services and the operation of the labour market may provide benefits which offset costs in other parts of the reform program. However, there is no a priori case for necessarily preferring a broadly based reform agenda to one with a narrower focus. Whether a narrow or broad-based policy has higher social gains is an empirical question. To support one over the other, it is necessary to demonstrate that it has a more favourable impact on social welfare and this will depend on the policy areas and the details of the policies. If a broad-based reform is not feasible this, by definition, restricts the options to a narrower range of policy options.

Phasing

Phasing reforms is another option, although the timing of a policy is just one aspect of the general problem of policy design. Inevitably, modelling involves uncertainty and rests on a number of assumptions. Large standard errors associated with policy predictions might suggest caution. Phasing in a policy reform may allow predicted outcomes to be tested and provide opportunities for refinements at a latter stage. Options involving different phasing arrangements (eg pre-announcements versus a gradual schedule of changes and different time periods) should each be modelled over a number of years and the present value of gains and losses compared with the potential gains of using other forms of assistance. Whether a phased implementation is preferable to an immediate introduction of the full policy change will most likely differ depending upon the type of policy reform. Phasing or pre-announcing a reform may provide greater adjustment opportunities that may limit the size of the losses.

However, even where a proposed reform is modified (modifying could also include phasing and/or carrying out a number of reforms in tandem), to address adjustment and distributional concerns, unacceptable impacts may become apparent *ex post*. This may be due to unanticipated welfare effects or large standard errors on predicted outcomes. The situation is then comparable to non-policy induced adverse welfare impacts. The government must then determine an appropriate response. This may entail reviewing pre-existing transitional or phasing arrangements, modifying existing social security and labour market programs or developing new industry or region specific assistance arrangements.

Compensation — some additional considerations

In the context of the proposed tax reform package, a number of inadequacies of the social security system, as a mechanism for delivery of compensation, have become apparent. Some of the reasons why compensation via the social security system may be inadequate include:

- Consumption patterns vary across households so a flat rate of compensation, based on say an average consumption bundle (such as the CPI bundle), is likely to both under and over compensate particular households. It is more likely to under-compensate those at the lowest welfare levels.
- Compensation schemes increase *income* for recipients of pension payments by the average increase in the cost of living. There is no compensation for the part of *expenditure* that exceeds income. This typically places the least well off pensioner-beneficiary household at greatest risk.

-
- Compensation is restricted to those in receipt of government pensions and benefits and fails to reach outside the system to those deserving of compensation. This gives priority to some categories of losers over others in the same welfare position. For example, there are many groups of losers from the governments proposed tax changes who would not be compensated by the increase in pension payments. These include fully or partially self-financed retirees, many working married women, young people, low income primary producers and recent migrants.
 - Compensation may be more readily eroded over time than an ex ante policy modification to address distribution consequences. Governments may fail to maintain the real value of compensation payments.
 - Compensation usually involves income testing and, as discussed below, the extension of income tests increases poverty traps in the tax-transfer system.

Having regard to this list, it is apparent that if trying to improve adjustment and distributional outcomes, it may be necessary to consider compensation over and above that available through the general social security system.

The following section looks briefly at tax transfer targeting and potential concerns in relation to the proposed tax reform package.

Targeted transfers and the proposed tax reform package

The increased use of targeted transfers in Australia in recent years reflects the view that income testing is necessary to make tax-transfer systems more efficient. While the motivation for this development is said to be efficiency, the argument rests on a different concept, that of ‘target efficiency’, developed by Beckerman (1979). To determine the extent of target efficiency it is first necessary to identify the target group for redistribution. The proportion of total transfer payments received by the target group measures the target efficiency of the payment.

A stringently income tested system usually achieves high scores on target efficiency since the eligibility rules direct payments to the target group (Mitchell 1990). However, it may be less efficient than a universal payment that delivers the same welfare gain to the poor (Kesselman and Garfinkel 1978). This is because the universal and targeted transfer both increase marginal tax rates but they do so for different groups. The targeted scheme raises effective marginal tax rates for those in the withdrawal range of the transfer. These tend to be those at low levels of welfare. When a transfer is paid universally, the government can choose which marginal tax rates are raised by the method of raising the revenue.

The relative efficiency merits of the targeted and universal schemes depend on the labour supply responses of the different groups. Empirical labour supply studies find labour supply elasticities of high earners to be small relative to those of low earners. Efficiency is likely to be worsened by a scheme which lowers the tax rates of high earners and either increases the withdrawal rate or the income withdrawal range of an income tested transfer.

Consider the governments tax reform proposal. As proposed necessities would be taxed at the full GST rate with compensation to some groups such as pensioners via an increase in pensions. Both increase their effective marginal tax rates. Large tax cuts (reductions in effective rates of tax) are paid to high income earners. This redistributes high rates of tax from those with low labour supply elasticities to those with high elasticities. The likely overall impact is to increase inefficiency and inequality of outcomes.

In most cases, pension increases are not well targeted to all losers and government should consider other forms of compensation. All options will change relative prices and in response, individuals will change their behaviour. Both efficiency and distributional impacts should be modelled, as part of the process of determining social impacts. There are no universal decision rules for the form that special compensation should take, however, there are some practices that should be avoided.

Many forms of special compensation give priority to some categories of individuals over others in the same welfare position. This causes a breakdown of the anonymity principle. One common example is where special compensation is provided on the basis of household income. Consider using a cashable tax credit to compensate for losses arising from a reform. To evaluate this form of compensation requires close examination of labour supply elasticities and of how the measure of need in the income test relates to welfare.¹⁶

As discussed above, household income is an inadequate measure of well-being and using it to determine tax liability or eligibility for family assistance is problematic.¹⁷ To do so unfairly discriminates against those families who work much longer to earn their income. Use of joint income as a basis of taxation or to

¹⁶ When joint income of spouses is used to income test transfers to families, families with a higher time commitment to market work are disadvantaged. To address adverse efficiency and equity effects, Apps (1987, 1998) shows that it can be preferable to target payments to households using the income of the primary earner. An alternative to this is to allow a threshold in the income test for the second earners in recognition of the loss of household goods and services and leisure time (see Savage 1985).

¹⁷ For some discussion in the context of joint taxation see Jones and Savage (1996).

income test benefits fails to recognise that welfare level depends on available options faced and not the choices taken. It unfairly disadvantages two-earner families. The effect is often to make them pay for the tax cuts or assistance of one-earner families who are far better off.

Using family income to target compensation has the effect of taxing the first dollar of the lower earner's (usually the wife's) income at the same marginal tax rate as the last dollar of the higher earner's income. The pattern of marginal tax rate changes and the implied welfare gains and losses determine the efficiency impact of the income test. Since married women's labour supply is usually found to be more responsive than that of husbands, a joint income test tends to increase the inefficiency of the tax system overall.¹⁸

The efficiency and equity merits of the tax credit form of compensation can be varied depending on how it is targeted, in particular, the choice of the income test. A well-designed income test can be introduced without compromising social justice objectives however it would require a major break with standard practice.

6.6 Conclusions

In his recent survey of empirical approaches to welfare measurement, Daniel Slesnick (1998, p. 2108) argues that:

The measurement of welfare forms the foundation of public policy analysis. A full consideration of taxes, subsidies, transfer programs, health care reform, regulation, environmental policy, the social security system, and education reform must ultimately address the question of how these policies affect the well-being of individuals.

Many of those who advocate an increase in the pace of microeconomic reform argue that it is appropriate to focus solely on efficiency issues. This reveals a fundamental misunderstanding of the major results of welfare economics. We inhabit a world that is second best in nature. It is not desirable to separate equity and efficiency goals or to assign some policy instruments to equity while assessing potential policy reforms solely in terms of efficiency considerations. Second best analysis attempts to take account of constraints on the set of feasible policy tools in realistic policy settings. Equity impacts must be addressed at the policy design stage.

¹⁸ For example, using US data, Boskin and Sheshinski (1983) find that where a gender-differentiated system is practicable, women should face marginal tax rates between one third and one half of those of men at the same income level to minimise the efficiency cost of raising revenue.

Welfare measurement is fundamental to the evaluation and design of successful policy reforms.

It is not possible to know the efficiency impact of a policy reform without estimates of individual or household welfare effects. Efficiency is enhanced only if the sum of gains exceeds the sum of losses. An efficiency gain indicates that the total ‘welfare cake’ to be distributed to individuals is increased and that it is, in principle, possible to redistribute these gains so that no-one loses. If there is an efficiency gain, social welfare is *potentially* increased. Whether there is an *actual* improvement for society depends upon the *distribution and size* of actual (not hypothetical) gains and losses in living standards and society’s ethical judgment regarding inequality.

To determine whether a particular policy is in the interest of society it is necessary to measure these welfare effects using data on actual households and firms within a framework which models behaviour consistent with the utility maximisation paradigm.

Several key messages emerge from this paper. They are:

- The efficiency only approach, which is frequently used to evaluate reforms, suffers from a number of fundamental limitations.
- Ignoring distributional consequences may well mean that policy reform reduces social welfare even if efficiency is enhanced. The sizes of gains and losses and where gainers and losers are located in the distribution of welfare matter.
- Information on individual gains and losses is necessary for determining whether a proposed policy is socially beneficial. The same information is necessary to determine whether there is an efficiency gain or loss.
- A broader approach to policy (which explicitly takes account of efficiency and distributional issues) is needed to be confident of identifying socially beneficial reforms.
- The standard practice in public economics is to formally integrate the design and implementation features of a policy reform. This practice should be extended to evaluations of all policy reforms.

References

- Albon, R. 1998, 'The efficiency effects of base broadening', Paper presented at the Joint Australian National University-University of New South Wales workshop on Public Finance, Australian National University, Canberra.
- Apps, P.F. 1997, *A Tax-Mix Change: Effects on Income Distribution, Labour Supply and Saving Behaviour*, Centre for Economic Policy Research Discussion Paper No. 371, Australian National University, Canberra.
- 1998, 'Effects of a tax mix change', *Australian Tax Forum*, pp. 401–27.
- and Savage, E.J. 1989, 'Labour supply, welfare rankings and the measurement of inequality', *Journal of Public Economics*, vol 39, pp. 335–64.
- Atkinson, A.B. and Stiglitz, J.E. 1980, *Lectures on Public Economics*, McGraw Hill, London.
- Beckerman 1979, 'The impact of income maintenance payments on poverty in Britain 1975', *Economic Journal*, vol. 89, pp. 261–79.
- Boskin, M.J. and Sheshinski, E. 1983, 'The optimal tax treatment of the family: married couples', *Journal of Public Economics*, vol. 20, pp. 281–97.
- Blackorby, C. 1990, 'Economic policy in a second best environment', *Canadian Journal of Economics*, vol. 23, pp. 748–71.
- and Donaldson, D. 1988, 'Money metric utility: a harmless normalisation?', *Journal of Economic Theory*, vol. 46, pp. 120–9.
- Blundell, R. and Lewbel, A. 1991, 'The information content of equivalence scales', *Journal of Econometrics*, vol. 50, pp. 49–68.
- Brown, S.J and and Sibley, D.S. 1986, *The Theory of Public Utility Pricing*, Cambridge University Press, Cambridge.
- Diamond, P.A. and Mirrlees, J. 1971a, 'Optimal taxation and public production I: production efficiency', *American Economic Review*, vol. 61, no. 1 (March), pp. 8–27.
- 1971b, 'Optimal taxation and public production II: tax rules', *American Economic Review*, vol. 61, no. 3 (June), pp. 261–78.
- Feldstein, M.S. 1972, 'Distributional equity and the optimal structure of public prices', *American Economic Review*, vol. 62, pp. 32–6.
- Freebairn, J. 1997, Efficiency issues in tax reform, Paper presented to the New South Wales Economics Society conference, 'Taxation Reform', November.
- Jones, G.S. and Savage, E.J. 1996, 'An evaluation of income splitting with variable female labour supply', *Economic Record*, vol. 72, pp. 224–35.

-
- Kesselman, J.R. and Garfinkel, I. 1978, 'Professor Friedman meet Lady Rhys-Williams: NIT vs CIT', *Journal of Public Economics*, vol. 10, pp. 179–216.
- King, M.A. 1983, 'The welfare analysis of tax reforms using household data', *Journal of Public Economics*, vol. 21, pp. 183–214.
- Laffont, J.J. 1989, *Fundamentals of Public Economics*, MIT Press, Cambridge, USA.
- Lewbel, A. 1989, 'Household equivalence scales and welfare comparisons', *Journal of Public Economics*, vol. 39, pp. 377–91.
- Lipsey, R.G. and Lancaster, K. 1956, 'The general theory of second best', *Review of Economic Studies*, vol. 24, pp. 11–32.
- Mirrless, J. 1971, 'An exploration in the theory of optimum income taxation', *Review of Economic Studies*, vol. 38, pp. 175–208.
- Mitchell, D. 1990, 'Targeting efficiency of social security programs', *Australian Journal of Public Administration*, vol. 49, pp. 12–16.
- Myles, G.D. 1995, *Public Economics*, Cambridge University Press, UK.
- Pollak, R.A. and Wales, T.J. 1979, 'Welfare comparisons and equivalence scales', *American Economic Review*, vol. 69 (Papers and Proceedings), pp. 216–21.
- Quiggin, J. 1997, 'Efficiency-versus social optimality: the case of utility pricing', *Information Economics and Policy*, vol. 9, pp. 291–308.
- Roberts, K. 1980, 'Price-independent welfare prescriptions', *Journal of Public Economics*, vol. 13, pp. 277–97.
- Rosen, H.S. 1992, *Public Finance*, 3rd edn, Irwin, Homewood, Illinois, USA.
- Savage, E.J. 1985, *The Family and Tax-Social Security Policy*, ACOSS Welfare Economic Monograph No. 1, ACOSS, Sydney.
- 1993, 'Tax reform and the tax free threshold', *Australian Tax Forum*, vol. 10, pp. 1–23.
- 1998a, 'Equity and efficiency issues in tax reform', Paper presented at the Joint Australian National University-University of New South Wales workshop on Public Finance, Australian National University, Canberra.
- 1998b, 'Trends in economic policy for the aged: an evaluation of user pays, cost recovery and means testing', in New South Wales Committee on Ageing, *Who Pays? The Impact of User Pays and Economic Policy on Older People*, NSWCoA, Sydney.
- and Hart, A. 1995, 'Environmental economic policy in a second best environment', *Economic Papers*, vol. 14, no. 2, pp. 1–16.

-
- Slesnick, D.T. 1998, 'Empirical approaches to the measurement of welfare', *Journal of Economic Literature*, vol. , pp. 2108–65.
- Stiglitz, J.E. 1988, *Economics of the Public Sector*, 2nd edn, Norton, New York.
- Treasurer 1998, *Tax Reform: Not a New Tax, a New Tax System*, AGPS, Canberra.
- Tresch, R.W. 1981, *Public Finance: A Normative Theory*, Business Publications, Plano, Texas.
- Warren, N., Harding, A., Robinson, M., Lambert, S. and Beer, G. 1999, *Distributional Impact of Possible Tax Reform Packages*, Report to Senate Select Committee on New Tax System, NATSEM, University of Canberra.

7 Structural adjustment: a mainly regional development perspective

Cliff Walsh

7.1 Introduction

In thinking about the subject-matter of this workshop, I was confronted by an overwhelming sense of *deja vû* — again!

This partly reflected the fact that, a few years ago, I was an Associate Commissioner (with Gary Banks as Presiding Commissioner) on an Industry Commission (IC) inquiry into *Impediments to Regional Industry Adjustment*, during which a number of the issues relevant to the workshop regularly raised their heads. Although Gary might not entirely agree, I think it would be fair to say we largely finessed them by setting them aside and focusing on the fundamentals. Meanwhile, the Kelty Task Force on Regional Development was charging around the country creating unrealistic expectations that massive infrastructure spending in the regions was a big part of the answer (which, of course, begs the question: ‘what was the question?’!).

However the sense of *deja vû* also has a deeper and, arguably, more fundamental basis.

A couple of decades or so ago, many analysts and observers claimed that the intellectual case for significant economic reforms in Australia had been well-established, even among politicians — especially within the Liberal Party’s Cross-Roads group, but also more generally. The problem, it was said, was that breaking through entrenched interests was too difficult, politically, to achieve, especially without compensation — and that the required compensation might prove unaffordable, or might dissipate the potential benefits of reform.

We know well that the central problem facing policy reform usually is that the costs tend to be highly concentrated and visible, while the potential benefits are diffuse and ‘speculative’ (during the not-very-great motor vehicles tariff pause debate a year or two ago, I was regularly confronted in South Australia, via the media, with

families who ‘feared for their future livelihood’ but, not surprisingly, never by families who looked forward to new and expanded job opportunities!). It’s also usually the case that many of the current beneficiaries of policy-bestowed privileges actually paid ‘full-tote-odds’ for their shares, licences etc. The *real* beneficiaries traded-in the capitalised value of the privileges years ago.

It isn’t all that long ago that analysts used these observations to diagnose or predict ‘sclerosis’, through capture of policy and politics by entrenched interests, as a cumulative disease confronting developed nations — most notably and clearly articulated in Mancur Olsen’s book, *The Rise and Decline of Nations* (1982). It’s a matter for debate precisely what’s happened since then, in various parts of the world, to result in many sclerosis-busting reforms. But the answers surely must include the determination and capacity of ‘fringe dwellers’ in financial (and other) markets to circumvent regulatory frameworks, the capacity of multinational corporations to go strategically offshore, and the discovery by less developed countries that, with more appropriate outwardly-focussed economic policies, they could out-compete even tariff protected producers in developed countries. All this, of course, was aided and abetted by rapid developments in information and communications technologies and by reduced real transport costs.

Many governments, including in Australia, confronted with the challenge of either changing policies or accepting national economic decline, found the will to create the counter-constituencies to support reforms. That hasn’t (yet) been totally undermined, but the experience of the last two decades of reform has, in recent times, resulted in what’s often referred to as reform fatigue, and, in some cases, reform resistance.

The questions posed of paper-preparers for this workshop imply that lack of compensation for adjustments to reforms may be a significant part of the reason or, at least, that they remain unanswered questions relevant, generally, to a period of significant structural change.

I don’t disagree that these are highly pertinent questions, and I eventually address some of them head-on. However, I want to, initially, develop a somewhat different angle on the issues and pressures that underlie the questions. Specifically, I intend to argue that reform fatigue or resistance has a much deeper cause which, if tackled more effectively, would, or should, relieve many of the tensions. That is, what prior to the 1980s was a bipartisan approach to ‘social policy’ in Australia has been replaced by a social policy vacuum that is badly in need of filling. I don’t claim to have a full answer to how the vacuum might best be filled but, drawing on several years’ experiences, I want to present an argument that suggests that, in a globalised world, good regional policy is a key to good social policy and, in turn, a key to

sustaining economic policy reform and building acceptance of continuing market-driven change.

This may, at first sight, appear somewhat orthogonal to the workshop theme, and to day-to-day roles and functions of the Productivity Commission more generally. However, I'm convinced that, both within its regular inquiry activities and in its more general role of promoting policy discussion and debate relevant to productivity and growth, ideas about more effective regional development strategies and policies have a potentially significant contribution to make. They are, in particular, directly relevant to addressing pressures for structural adjustment assistance.

My arguments in support of this proposition proceed as follows. In section 7.2, I briefly, but very critically, review the traditional 'welfare economics' literature's approach to social policy. In section 7.3, I turn to what, as I see it, acted as a social policy framework in Australia from (at least) the 1920s until the 1970s — albeit splintering after the mid-1960s. In sections 7.4, 7.5 and 7.6, I examine how the vacuum created by the loss of this social policy approach might (at least in substantial part) be filled by a more focussed and effective adoption or adaptation of new models of regional development, drawing on experiments in Europe and elsewhere. Section 7.7 draws together my broad policy recommendations as they relate to regional policy generally; section 7.8 focuses more directly on the key questions about compensation for adjustment costs and distributional effects; while section 7.9 provides a brief overview of my conclusions.

7.2 The weaknesses of old welfare economics

Ideally, you would have thought, the starting point for addressing the central questions posed of all authors for this workshop would be found in the so-called 'welfare economics' literature. Unfortunately, this turns out not to be true, for at least three distinct reasons.

The first reason is that that literature (especially closely associated with the names Pareto, Kaldor, Hicks, Baumol, Bergson and Samuelson and, more recently, Stiglitz and Atkinson) exhausts its potential contribution at precisely the point that our key questions arise. That is, while it has been valuable in highlighting the often complex issues involved in assessing whether changes are *socially* beneficial and in providing conceptual underpinnings for practical analytical frameworks, such as cost-benefit analysis, it doesn't and can't resolve the central question — in effect, whether 'potential compensation' is sufficient to support a change as welfare-improving, or whether 'actual compensation (of at least some)' is required?

A second reason is that the whole framework of traditional welfare economics is comparative static. In a world which is so obviously subject to rapid market-driven technological change, it's something of an oddity that measures of the benefits (and costs) of reforms in response to those changes have been restricted to the 'one-off' consequences of resource reallocation. Little or no attempt has been made to try to assess how they might contribute to the rate of innovation or adoption of new technologies, and with what additional welfare consequences, positive and negative.

A third reason for the failure of the traditional welfare economics literature to help us with the key questions, is that it's totally thread-bare when it comes to recognising the role and significance of 'institutions', broadly defined. I can best illustrate this by way of a couple of examples.

First, in Australia we have a federal system of government. This means that two 'spheres' of governments have a guaranteed right to exist and to exercise autonomous powers in the interests of their respective voters/taxpayers/citizens. Some of these powers are exclusive, but most are (one way or another) shared. In any event, as democratically-elected representatives of their respective citizens, both spheres have a legitimate interest in all that affects the well-being of their citizens: federal systems inherently put 'national' and 'regional' interests sometimes in conflict. Given this political context, I don't see how you can take a purely 'national' evaluative perspective on change and reform. The traditional framework encourages analysts to think of distributional issues as essentially about people or firms, irrespective of their location. Inconvenient as it may appear, our chosen political structure *implies* that individuals' regional, as well as national, locations enter the Social Welfare Function, it seems to me.

The second example is also place-related, but in a somewhat different sense. The well-being of people and communities depends on all the resources and infrastructure accessible to them — for example, social support structures, administrative and political structures and environmental resources, as well as their economic resources and infrastructure. Economist's approaches, whether traditional or modern, to evaluation of policy changes assume that broader social and other factors which bear on well-being not only can be taken as given, but also that, by and large, the social, environmental and administrative infrastructure relevant to them is sufficiently robust to enable people and communities to absorb the stresses of economic change. The reality, however, is that, especially outside the larger metropolitan centres, these presumptions are often *not* valid. Smaller regional and rural cities, towns and communities often have narrow economic bases, shallow and fragile social support systems, and lack the administrative strength and political muscle to enable them to adapt to or absorb rapid or repeated change. Even

communities facing expanded opportunities experience intense social and administrative stresses in attempting to capitalise on them.

Some, but not all, of these deficiencies in traditional welfare economics approaches have been partly overcome by either theoretical advances or pragmatic responses by policy advisers.

For example, ‘Schumpeterian’ Austrian and neo-Austrian approaches to understanding dynamic economic developments clearly challenge the traditional neoclassical welfare economics approaches, and their comparative static content. However, they haven’t (yet) provided a coherent alternative ‘welfare framework’ that is widely understood and agreed.

Likewise, branches of the public finance and other literatures which have developed ‘constitutional’ approaches to understanding institutions and policies, have added to traditional approaches. For example, by stressing that ‘behind a veil of ignorance’, we’d likely choose institutional arrangements that ensure at least a minimum degree of equity *in outcomes*, they strengthen support for the ‘actual compensation (for some, at least)’ approach to assessing welfare effects. However, how their general guidance appropriately is converted into practical criteria remains uncertain, and probably incapable of being made practically overt.

At a more pragmatic level, many analysts and advisers accept that ‘the politics of policy advice’ requires that gainers and losers should be explicitly recognised and identified among policy options that are identified as ‘efficiency improving’. That, it seems to me, is the minimum information we should provide to policy-makers — clearly and loudly, so that they are challenged to justify their policy choices against clear and unambiguous information about who really are the losers and/or gainers from chosen options and where they sit in income-distributional terms. Their geographical location, and the consequences for the communities in which they live and work also are key pieces of information with which policy-makers should be confronted — which should be made publicly available, not restricted to the Cabinet room.

It’s surely information of this sort, once it’s been fully understood by decision-makers, that has helped to promote achievement of efficiency-generating reforms such as deregulation of housing interest rates and tariff reduction strategies.

This isn’t to say, however, that reforms that promote both efficiency and distributional equity will win-out at political level, even among well-informed policy-makers — particularly if they lack the will or the capacity to mobilise counter-constituencies to entrenched industry and/or regional interests. And this is where, pragmatically speaking, the ‘to compensate or not?’ issue bites hardest.

Although economists are neither uniquely, nor generally, well-equipped to make distributional judgements — and neither are we ‘approved agents of society’ to make decisions based on such judgements — we’d surely agree that obviously regressive impacts of reforms (particularly if they’re liable to be cumulative over time) establish an *a priori* case for schemes of *interpersonal* redistribution that might go beyond relying on existing tax-transfer mechanisms to do the job. If there’s one clear message from decades of theorising about welfare effects, it is that the (Musgravian) assumption that efficiency and distribution effects can be separated, and the latter can be left to be corrected by ‘the distribution branch of the public household’, is pure fiction, conceptually as well as practically.

So, albeit with some reluctance and trepidation, changes which have major, economy-wide distributional impacts could/should be argued to qualify for some form of compensation (or packaging, or phasing, depending on their nature and extent). I raise this again, later, in relation to exceptional circumstances.

But what can we do/say when it’s evident that desirable change — in equity as well as efficiency terms — is at risk? Sensing the direction in which the motor vehicle tariff phase-down debate was heading in late 1996 and early 1997, I suggested that it would be preferable to temporarily ‘tax’ potential gainers from continued phase-down (domestic motor vehicle purchasers) to compensate specifically those whose jobs would be lost as a result. Quite apart from the information deficit we’d face with implementing such a proposal in specific circumstances (including because dynamic effects aren’t well-modelled, or modelled at all, with present methodologies), the question arises: ‘would including such proposals on the policy-choice menu — sporadically or consistently — lead to risks of moral hazard (ie agents putting or painting themselves directly at risk) or of increased (political) demand for compensation even in inappropriate circumstances from an equity viewpoint?’.

I return to these and other related issues later, especially in section 7.8. The point to be made here, however, is that pragmatism in responding to tricky issues isn’t obviously ‘welfare enhancing’ in the long-run, when the on-going consequences of one-off decisions make themselves repeatedly felt.

7.3 Social policy in a vacuum

At least since the 1920s, until the 1980s, ‘social policy’ in Australia had a bipartisan underpinning. Although it’s a tad simplistic to put it in this way, it seems to me that that policy principally consisted of a system of tariff protection to promote manufacturing employment as a support for population growth, and a centralised

wage fixation system which ensured that those in work received a basic, living wage. Categorical benefits for those not in the workforce (through unemployment, incapacity or retirement, for example) provided a safety net.

Post WWII, this social policy framework supported widespread access to the benefits of growth, until at least the mid-to-late 1960s. It might, of course, have resulted in lower growth rates than otherwise would have been achieved, but until the mid-1960s, manufacturing employment grew consistently and unemployment rates were very low by current standards. We were, as we saw it, in a ‘golden age’.

This social (*cum* economic) policy framework began to fall apart after the mid-1960s, when manufacturing employment began to decline. The reasons for this are multifaceted, but include both that mining booms (especially in Western Australia) pushed up the \$A exchange rate to the disadvantage of domestic manufacturers and also that the Asian economies were growing as competitors to Australia in its traditional markets (domestically, and in Europe and the United States).

Not least because they had become central planks of *social* policy (as well as, ostensibly, economic policy), protection and centralised wage fixation remained as bipartisan elements of Australia’s policy approach until, roughly, the mid-1980s, notwithstanding that some of their objectives were being much less well met during the 1970s.

The challenges to this social *cum* economic policy framework intensified over time, of course. The one consistent theme, however, has been that globalisation has been the key to their demise. Initially, this involved simply ‘external competition’ to Australia’s manufacturing competitiveness: more recently, a broader set of competitive forces have become involved — including the implications of IT&T technologies for financial and other service sectors, and the implications of international institutions’ scrutiny for economic and social policy-making more generally.

I refer, here, of course, to the fact that financial markets daily, indeed hourly, assess and reassess our economic potential, and that international financial institutions such as the International Monetary Fund, the World Bank and, importantly, the Bank for International Settlements affect our ratings. But I also refer to a broader range of international influences, including, for example, United Nation affiliated organisations judging our performance on social and environmental issues — not least because Australia often has signed up to socially-based international agreements.

We can’t ignore these broader social policy contexts, but the reality is that the economic components of the ‘social union’ we implicitly agreed to in 1901 are

under increased pressure to prove that they are beneficial and sustainable. This is all part of a now widely recognised phenomenon of formerly clearly ‘sovereign’ governments losing their presumed monopoly control over national outcomes, and the drivers of them.

In response to the new global challenges, Australian governments, and policy analysts, have left a vacuum. Tariff protection and centralised wage fixation no longer provide a social support mechanism for Australia’s economic and community development. Tariffs are, inexorably, on the way down, and manufacturing employment, overall, can’t expect to do better than hold its aggregate level. Wages and industrial relations, inevitably, will become increasingly enterprise-driven as the imperative of being internationally competitive (productive) becomes more widely recognised.

But while we’ve been ‘doing’ the efficiency/effectiveness/productivity ‘thing’, the question of what’s to replace our previous core planks of social policy has been neglected. This, it seems to me, goes a long way towards explaining why we’re facing so-called reform fatigue (or reform resistance).

My view is that we’ve entered a social policy vacuum because, on the one hand, the largely ‘right-leaning’ reformers have been consumed by how to make change happen in response to pressures emanating from globalisation while, on the other hand, the ‘intellectual left’ has been concerned with trying to resist the forces and implications of globalisation, to the point where thinking about how to coordinate economic forces and social policies would be to concede that changes caused by globalisation are inevitable, which they don’t want to concede.

This has begun to change recently with, for example, the ‘new-wave’ or ‘third-wave’ thinking of Tony Blair’s British Labor Party and publication of books by two of their Australian Labor Party acolytes (Latham 1998; Tanner 1999). I don’t want to buy into their arguments directly but, rather, to offer a perspective based especially on recent experiences of consulting with regions and State government agencies about their experiences in a ‘globalised world’.

In this context, the timing of the preparation of this paper is a little unfortunate in two respects. First, it precedes the draft Productivity Commission report on the impact of national competition policy on regions, which obviously has a direct bearing. Second, it also precedes the release by the South Australian Government of the report of the SA Regional Development Taskforce (of which I was Deputy Chair), which constrains me, somewhat, in what I can say about its conclusions.

Nonetheless, there’s much to be said that doesn’t depend on those reports and there should be an opportunity to work aspects of them into the workshop discussion.

7.4 Globalisation and regional development

I start from the simple, but (I think) important proposition that, ultimately, what we are interested in, in welfare terms, and what governments are (or should be) responsible for, is the quality of life of people and communities — all people, in all communities. This obviously depends, fundamentally, on access to incomes, and the basic means of getting access to those incomes (or, at least, access with dignity) for most of us is jobs. But it's about much more besides. It's about whatever impacts on peoples' access to resources: it's about the way that political institutions and administrative arrangements work, or don't work, to give people in communities access to services, influence over what services are delivered and how they are delivered; it's about the way non-government institutions (what nowadays tends to be called 'civil society') support, or fail to support, peoples' access to incomes and services and security and other things they want or need in life; and it's about much more too.

That is, regional and community development isn't synonymous with regional economic development — the social, cultural, administrative, political and environmental underpinnings are essential to sustainable economic, as well as community, development.

If all that is agreed, then three things follow.

The first is that we need much richer information about — and a much more integrated understanding and analysis of — the key factors and forces that shape, and either encourage or constrain, community development and the quality of life in different regions to inform 'good regional development policy'. What we really need is a complete 'map' of communities and regions — identifying all of their resources and all of their infrastructure — social, political, administrative, cultural and human, as well as economic and physical resources and infrastructure. No government integrates all these perspectives or dimensions and none has interregional models that allow us to fully assess regional impacts of policy changes, or national or State impacts of regional changes.

What information we need, and why, is driven by the second implication: that is, good regional policy is a matter of identifying the key weaknesses in the way that communities and regions 'work', and giving policy priority to tackling those weaknesses, whether they involve the economy of the community, the institutions of the community, access to administrative or political resources, the structure of social institutions, or whatever. Impact analysis of market-driven changes or policy-inspired reforms need, in other words, to be both social and regional in their content. If they are not, they fail to provide policy-makers with policy-relevant

information, and condemn policy-analysts to potential frustration or impotence, if not irrelevance. Our current modelling and analytical frameworks don't recognise this fact sufficiently to rescue themselves from claims of being irrelevant. They are comparative static (which obviously makes them weak, if not misleading) and they invoke *ceteris paribus* assumptions that (implicitly) assume social, cultural, administrative and environmental consequences, for example, can be absorbed or addressed by other community mechanisms, which often isn't the case.

The third point is that, therefore, good regional policy is very 'community and region specific' and it's also 'time specific'. The framework within which we think about these issues needs to be applied to specific local and regional circumstances.

What's obvious today, is that fundamental structural changes occurring in Australia (and everywhere else) are putting the value of many regional resources at risk, and putting regional institutions (political, administrative, non-government and so on) under stress — and not only in rural and remote Australia, although the pressures may be felt more sharply in those sub-sets of regional Australia because support systems are much less resilient and less deep than in larger capital and provincial cities.

Throughout Australia's history, its regions (however defined) have been characterised by diversity and confronted by change. The difference today, at least as perceived by regions, is that the scale and pace of change has accelerated to an extent that even those regions which are potentially advantaged by it are feeling stressed. Most statistical measures of regional 'fortunes' suggest that differences in regional performance have widened, whether regions are defined as States or distinct sub-State areas.

The reasons aren't hard to explain. They consist of a mixture of both, on the one hand, direct market forces and, on the other, policy changes largely in response to those forces. Put in simple terms, globalisation (or international integration) of financial and product markets, technological change, and improvements in transport and communications technologies have, in turn, led to business restructuring and to policies favouring deregulation and enhanced competition, including in public sector service delivery, and to public sector outsourcing and downsizing.

Although, in absolute terms, these trends have impacted most on where most people live and work — in 'the cities' — the impacts on non-metropolitan regions often have been more acute. In smaller communities, even the (initial) loss of a few public or private sector jobs can lead to a cumulative spiral of decline as other services or businesses lose critical mass. Equally important, smaller or more severely affected regional communities often lose people who previously had

decision-making capacity, or influence, based on local knowledge, and/or people with community leadership skills.

Where is all this leading, you might be wondering by now? To reassure those who suspect that I'm about to reveal that age has dulled my reformist enthusiasm, let me say, immediately, that I'm not about to promote a case for artificial policies of regional decentralisation of public sector service management and delivery or, worse yet, penalties on private sector service deliverers who abandon or diminish their regional presence.

Indeed, neither in studies undertaken by the SA Centre for Economic Studies into the 'problems' felt by South Australia's six provincial cities, nor in the SA Regional Development Task Force's wider consultations, did regional communities give principal emphasis to transferring jobs or 'buckets of money' to them. Rather, they principally expressed a sense (frustrated) understanding of the changes that were occurring, and of the limited capacity of governments to resist or avoid them.

What regions particularly emphasised, however, was:

- a sense of a lack of political permission and empowerment to drive their own futures, and a lack of 'voice' in decision-making processes that affect them;
- a feeling of a lack of knowledge and appreciation by decision-makers in capital cities of the contributions that non-metropolitan regions make to State and national economic and community development;
- a distinct sense that public sector agencies operate within a 'silo' mentality, which results in lack of communication between them, and coordination across them, in relation to regional service delivery strategies, including about their plans for rationalising staffing in regions; and
- an absence of, or deficiencies in, appropriate mechanisms for ensuring that capital works budgeting processes give regional infrastructure deficiencies and needs the priority they deserve.

Of course, perceptions aren't always synonymous with reality. But the SA Regional Development Task Force found sufficient evidence, including from state government agencies, to be convinced that there was substance in most of these claims, and that the Commonwealth shares in the guilt.

There is something of a paradox here. At a time when, internationally, governments are being forced to recognise that, in a globalised world, regions are increasingly more important units of competition and linkages with other national economies, Australia's regions are feeling increasingly isolated and remote from decisions that

affect them, and turning inwards because they believe central governments no longer have the capacity or the desire to address their needs.

Without wanting to make too much of a meal of it, it seems to me that the much discussed dissatisfaction and disaffection with politicians and political processes that have been evident in Australia in recent years are, in large measure, explained by views, such as those set out earlier, expressed by South Australia's regions. In particular, they go a long way towards explaining why there's a sense of reform fatigue (or resistance). Of course, traditional industry or sector based interest groups have capitalised on them to try to defer or deflect reforms, but I would take a great deal of persuading to change my view that the sense of isolation and lack of empowerment felt by non-metropolitan regions isn't the real core of the problem.

7.5 Responding to the regional challenge

The dynamics of regions have changed in response to complex forces. The policy implications of this new environment — where regions are, more than ever, the location of competitive advantage — pose a challenge to 'central' governments. Internationally, there is a clear trend towards an increased focus on regional development policy, but this is yet to be fully recognised and activated in Australia.

Successful strategies adopted by governments overseas have:

- mixed high level strategic and local level responses;
- shifted away from top-down models of regional development, characterised by centralised control and limited local involvement in decision-making;
- created community-based, 'bottoms-up' strategies;
- devolved decision-making to regional and local levels to ensure that it is more responsive, efficient and responsible;
- established partnerships and collaborative arrangements between governments, unions, businesses, non-government organisations, and other local interests;
- recognised the importance of ensuring that regional development agencies are responsive to, and able to identify, the needs of businesses and communities they serve;
- balanced the provision of incentives to attract new businesses with an increased focus on fostering indigenous growth;
- developed mechanisms to ensure that governments are more responsive and better able to integrate local input into decision-making;

-
- provided special assistance measures for regions particularly struggling in their attempt to adjust to pressures of social and economic change; and
 - acknowledged that market-led forces cannot be relied upon solely to create growth.

There is an emerging trend of governments recognising that tackling the effects of change — through improving regional competitiveness and assisting regions in need — requires a blend of traditional policy responses and innovative arrangements. Underpinning these approaches is the recognition that new ways are required to address the needs of the most vulnerable, and that special assistance measures should be provided for regions in need.

This isn't to say that all people in all regions can expect to receive assistance for changing their fortunes. There is, however, both a moral obligation to ensure that those who can't help themselves are given at least safety-net support and that incentives are created for regions and communities to take the lead in creating new bases for building competitive advantages. Where incentives need to be focussed, however, is not on compensating regions and communities for the ills that they have suffered but, rather, on supporting the strategic planning processes for promoting and managing change.

Frankly, the problems currently confronted by regions are little different in character, but they are undoubtedly much larger in scale and pace, than in previous periods. Many of them are essentially transitional. That is, we need regionally-sensitive education and training systems that, in future, provide opportunities for lifelong education training and retraining, especially in response to differences in 'regional' needs. We also need mechanisms to reinforce and support opportunities for technology transfer, and innovation more generally, in regions. In the meantime, there are people and businesses who are disadvantaged by the failure of existing education and training systems to equip them for change. Best as we can do, we obviously should encourage them to adopt 'change strategies'. But we also have a responsibility to support them if they can't adapt to the new circumstances.

That is, if individuals are confronted by rest-of-lifelong incapacities to adapt to change, then they should have available at least rest-of-life safety net support mechanisms to support a minimum acceptable quality of life. The problem, as always, is that distinguishing the genuinely life-long disadvantaged from those who lay false claim to disadvantage is virtually impossible — except by putting the genuine and the false into equally punishing living environments from which those who are able would want to escape. The trade-off between compassion and getting long-term incentives right is a tough-one.

Returning to the main theme, however, that many reports over the years have emphasised and confirmed that the real key to regions building on their own capacities is local leadership (see for example, the McKinsey Report, 1994 and its follow-up report, 1996). These reports emphasised the importance of leadership at both the regional and business level and spoke of improving leadership by creating ‘a learning environment’. They also, importantly, linked government support for regional leadership development with reorienting the role of regional leaders away from the ‘cargo-cult’ mentality of seeking grants and other forms of funding towards a focus on strategic planning to seek to maximise on, or redevelop, their competitive advantages.

Relatedly, in parts of Europe — most notably in northern Italy and (southern) Ireland — successful models of *community based development* have evolved from which other regions can learn.

7.6 Community-based development

The concept of community-based development has developed in response to the realisation that local efforts play a vital role in achieving sustainable economic and community development, particularly in communities adversely affected by social and economic change. Traditional approaches to economic development typically rely almost solely on ‘getting the fundamentals right’, or waiting for the economic and social benefits of ‘the trickle-down effect’ to flow through to local communities. In contrast, community-based development involves using all the resources available to local communities to drive their economies and stimulate sustainable economic and employment growth and broader community development. Within this model, the goals of social justice (at least as reflected in the concept of ‘community development’ in its broadest sense) and economic development are addressed simultaneously, rather than being treated as if they can be separated and/or treated sequentially.

The philosophy and practice of community-based development can be summarised by recognising that it:

- builds on the simple premise that a community has, within itself or within its grasp, considerable capacity and opportunities to influence its economic future;
- is not a panacea for all the problems and changes impinging on local communities. Rather, it must be viewed as a complementary strategy to broader state, national and global influences, which will still be the major determinants of wealth and job creation in any community. However, community-based

initiatives enable a local area to respond to these wider forces, to adapt them and to capture potential opportunities; and

- calls for a new way of thinking about the nature of public leadership by all spheres of government (MAV 1994).

Successful communities are characterised by a culture of collaboration and partnerships, based on a philosophy of integrating the economy and society. They understand that successful regions are based on public and private sector collaboration and on adequate social and cultural underpinnings, among other things.

There is a body of international research into successful and competitive regions that highlights the role of community-based development. Community-based models call for a different role for government in supporting and facilitating regional development, as well as new strategies for regional development practitioners.

This isn't the occasion to attempt to fully set-out precisely how such models might best be helped to work. But there are a few elements worth briefly setting-out.

- First and foremost, they involve regions taking the lead in creating long term strategies, based on locally-tailored solutions for local needs, designed to promote sustainable long-term growth.
- They also, importantly, involve public-private-community partnerships, in which governments cooperate with regions and support them in their efforts to help themselves.
- Particularly strong recognition is given to the need to tailor-make (life-long) education, training and retraining strategies to specific local needs, and with the capacity to adapt rapidly to changed circumstances and/or new opportunities.
- The role of innovation and technology transfer in the fortunes of regions also is strongly recognised, and supported both through networks of professional extension services and through assisting regions to build strong clusters and networks across supply and production chains.
- There's more than lip-service paid, too, to the importance of building and strengthening all the non-economic resources and infrastructure ('the social capital') of communities and regions, as a key element both in well-being, broadly defined, and in the sustainability of economic development.

This all probably sounds rather 'warm and fuzzy' to hard-headed neoclassical or neo-Austrian economists. But there is cumulating evidence that it works and, to

return to our central context, that it works in ways which help to make regions more open, and capable of adapting to change — whether market-driven or policy-driven.

I'm not anywhere near suggesting that a system of Australia-wide 'community-based development' strategies would be a panacea for all the consequences of change and the political pressures that arise from them. But the alternative of telling regions that 'getting the fundamentals right' will benefit them in the longer-term, if only through trickle-down effects, doesn't seem economically, let alone politically, smart. Yet, that's more or less the approach that Commonwealth and State Governments have adopted while promoting regionally painful change/reform in recent years.

At least since the failed Whitlam decentralisation strategies, successive Commonwealth Governments have adopted positions on regional development ranging from benign neglect to 'damned if we really know what to do' or even (recently) 'it's not our responsibility'.

Since everything the Commonwealth does is, in effect, regional in its consequences, this often leads, at best, to incoherence and inconsistency in relation to issues which have significant capacity to affect national economic and community development. A classic example is provided by the recent Regional Telecommunication Infrastructure Fund (from the first tranche of the sale of Telstra). Even setting aside the Harradine effect, (giving Tasmania a disproportionate share), its method of disbursement within States almost guarantees a lack of a strategic approach to 'connecting' regional Australia.

At worst, it leaves the Commonwealth exposed to having to deal with regional problems and pressures 'on-the-run'. Ten million dollars of Commonwealth funds went to match State funding in the aftermath of BHP's accelerated Newcastle closure announcement. This involved negligible losses of jobs relative to the region's total employment and future growth prospects, especially compared to the job and population losses experienced by other regions across Australia.

7.7 Broad policy implications

Two specific sets of questions are raised by what I've said to this point:

- The first concerns the appropriate roles of governments in regions: what would be the essential elements of a sound regional development policy framework?
- The second concerns the appropriate role of compensation, or structural adjustment assistance, in such a regional perspective?

This section looks at the first of these questions. The second is addressed in section 7.8.

7.7.1 The place of regions in politics and policy

To a politician, the most natural definition of a region is ‘the area covered by my electorate’! Based on a mixture of how persuasive and/or persistent individual MPs are, and how ‘marginal’ their electorate is perceived to be, ‘regions as electorates’ receive greater (or lesser) assistance from governments’ programs of service delivery and, even more so, industry, employment and community development assistance grant schemes, capital works programs and so on.

From a more strategic whole-of-state and/or whole-of-nation perspective, this natural political interest in regions doesn’t necessarily translate into a coherent ‘regional development policy and strategy’. On the contrary, it can lead to fragmentation and incoherence that results in missed opportunities for maximising regional potential.

Following the Whitlam Government’s perceived failure to achieve its regional (essentially decentralisation) objectives — and in particular, the debacle of the Regional Economic Development Scheme (REDS) — it took nearly 20 years for the Commonwealth to re-invent anything like a strategic approach to regional development. When it did, via the Kelty Task Force under the Keating Government, it was largely as an add-on to the *Better Cities* program. The Commonwealth provided start-up funding for Regional Economic Development Organisations (REDOs), the areas covered by which were defined by the Commonwealth without regard for existing state-based structures. At the same time, DEETYA established a system of Area Consultative Committees (ACCs) to advise it on labour market trends, pressures and problems. There was no formal coordination between ACCs and REDOs.

It is generally agreed that most REDOs achieved little or nothing of lasting value. Their funding was phased-out following the Coalition’s 1996 election victory (supported, in part, by a claim by the National Commission of Audit that the Commonwealth doesn’t have a constitutional role in regional policy). ACCs still exist and have taken on some of the expected functions of REDOs as points to tap into Commonwealth funding of significance to regions (eg RTIF, NHF, etc).

After three years of having nothing much by way of a regional policy framework, and following the experiences of the Queensland, federal and New South Wales elections, I understand that the Commonwealth Department of Transport and Regional Services is rethinking ‘the Commonwealth’s role in regional policy’.

At state government level, the pressures to connect with regions have, perhaps, been more persistent and insistent, but the focus has lacked consistency and often structure. The system of state and local government funded Regional (Economic) Development Boards that South Australia now has, for example, have evolved from initiatives taken only a little over a decade ago.

The increased attention to regional development that's evident in the South Australian Government's decision, last year, to establish a Regional Development Task Force, and, also, for example, in a variety of inquiries at national level into regional impacts of national policies (eg into employment and unemployment in regions and into the impacts of National Competition Policy (NCP) on rural and remote areas) probably has many explanations. But the political pressures/stresses that have been created or accelerated by globalisation and related policy reforms surely are the most potent.

7.7.2 Towards recalibrating the roles of governments

The history of involvement by 'central' governments in Australia (state and Commonwealth) in regional development, arguably, has been characterised by governments largely delivering services *to* regions, at their volition, and supporting regional development, more generally, through imposed policies, strategies and initiatives, rather than being responsive to and supportive of regional priorities and preferences.

This isn't entirely surprising. The effort, energy and resources that inevitably go into promoting regional differentiation in 'central' government policies and responses is potentially very large and uncertain in its ultimate outcomes. Treating the nation, or a state, as if it was homogeneous in most critical policy respects makes administration of policies and programs easier and, in earlier economic times, may not have been overly offensive to regional communities.

In the context of increased diversity in the forces impacting on regional communities and the consequences of them, however, centralised views of regional needs, and one-size-fits-all responses, have become less well-received politically and less effective economically and socially.

Both the Commonwealth and South Australian governments are (in different ways) reviewing their regional policies. This is a critical moment that needs to be capitalised on by state and Commonwealth governments to ensure a better coordinated and integrated response by both to regional development needs in the states. The central message must be that regions want to be *partners* in promoting

their economic and community development, rather than having policies and initiatives, and supporting advisory or administrative structures, imposed on them.

The model that has evolved in the Hunter region, following the BHP decision to close down, which is now being adapted to South Australia's upper Spencer Gulf region, provides clues about directions for adversely affected regions. Its key elements can be applied to regions that are (potentially) booming, but constrained by lack of infrastructure or perverse policies.

At the core of these models is a presumption that what's needed is:

- (a) a joint agreement between Commonwealth and state governments that they have a shared interest in regional development;
- (b) a protocol governing how the Commonwealth and each state will collaborate to promote regional development; and
- (c) provision within the protocol that both 'central' spheres of government will consult and cooperate with regional leaders in the design of strategies and policies to support regional development, and allow regions themselves to take the leadership role.

Ideally, such an approach would lead to increased decentralisation or devolution by Commonwealth and state governments to regional and local organisations of economic (and possibly community) development strategy development and implementation in areas or with respect to functions that are mutually agreed to be best driven at local/regional level.

The notion that regional development is a 'joint task' of Commonwealth and state governments corresponds to *both* how other federal systems have managed similar responsibilities (especially the German Federation) *and* how Australia manages its relationships with its international development cooperation partners.

The key elements would include removing the typical assumption of regions that the role of governments, principally, is to provide ideas for change and funding (whether for infrastructure or investment attraction). Regions would be primarily responsible for strategy formulation, in consultation with governments as well as other major stakeholders.

What governments would take responsibility for would include agreement to:

- support coherent and well-researched regional strategies;
- more effectively coordinate their planning, management and delivery of services and support within and across regions;

-
- look for opportunities to devolve (or at least decentralise) to local and regional organisation functions that could strengthen the capacities of regions to promote their economic and community development, with appropriate parallel devolution of financial resources; and
 - recognise the need for variations in approaches and strategies to allow for regionally ‘tailor-made’ strategies, rather than trying to impose centrally designed approaches.

As noted earlier, with both the South Australian Government and the Commonwealth reviewing their regional policies, a window of opportunity exists to develop a new regionalism in South Australia (and elsewhere), better attuned to the forces and consequences of an increasingly globalised world.

The SA Regional Development Task Force’s conclusions and recommendations reflect these sorts of considerations. That is, while it responds to its detailed terms of reference, it does so within a broad framework that proposes a better integrated system for regional development, encompassing the State Government, Local governments and regional organisations, building in an evolutionary way on existing strengths. The Commonwealth’s role would appropriately be to support and contribute to this State-wide integrated system.

As I said at the outset, I don’t suggest that a more coherent national approach to regional development will resolve all the problems and pressures that confront reform processes. Indeed, it can be seen as potentially something of a two-edged sword. On the one hand, developing wider regional perspectives on the impact of change can help to de-emphasise the consequences for specific firms or product types. On the other, by facilitating the ‘bulking-up’ of the political voice of communities into larger regional groups, we may be helping to create more effective regional lobbies.

The hope is that, by encouraging community-based type regional development models which emphasise regional leadership and regional ‘planning’ for change, supported and facilitated but not controlled by ‘central’ governments, we can increase the sense of regional empowerment and capacity to adapt. Adaptable regions are less likely to be reform-resistant.

I should, of course, add that this implies that Commonwealth and state government agencies, and local governments, need to be effective and flexible in their delivery of services to regions to a much greater degree than they have been in the past. Adaptable regions, among other things, require adequate, accessible, appropriate and responsive systems of education and training and retraining; effective transport networks; adequate health and community facilities; support for voluntarism and for

the work of non-government organisations; access to support for commercialisation of business ideas or innovations and/or adoption of new technologies; and, above all, support for innovative systems of regional governance.

The level of improvement required in intragovernmental coordination and intergovernment cooperation required to better support or to encourage regional adaptability is very large — and it involves as much of a focus on building social, administrative and political capital as on developing the human and physical capital of regions.

7.8 Compensation and all that

The broad thrust of my argument, at least by implication, has been that a more effective national regional policy framework, involving all spheres of government cooperating with regionally-based organisations, can help to reduce demands for, and expectations of, compensation for change. At the very least, within the context of a more coherent regional policy framework, there would be a strengthened capacity for governments and their agencies to differentiate between regions which have accepted the idea that they need to lead the change process from those which haven't, and to differentiate any support, not only according to the severity of regional adjustment problems, but also according to the extent to which regions themselves, including businesses in them, have developed strategic approaches to building or rebuilding competitive advantages.

Underlying this, although left unsaid to this point, is a presumption that 'compensation' for change — whether market-driven or policy-induced — is generally undesirable, other than in truly exceptional circumstances. This, of course, begs the question of what circumstances are *truly exceptional*. But let me first explain why I want to generally support the 'no compensation' principle.

First, so far as the distinction between structural adjustment costs and distributional effects of policy-induced and market-based changes are concerned, *in general* it involves a false dichotomy, in several senses:

- Decisions are made (whether about shareholdings or skills acquisition or whatever) in the knowledge that their value is uncertain — not only because market demand and supply conditions can change, but also because government policies can change. To compensate for adverse changes in one and not the other would be somewhat akin to punters at the races having losing pre-race bets repaid if the stewards changed the start-finish line just before the race because of an immediate pre-race downpour, but not if the downpour occurred during the race.

-
- It's impossible, in most circumstances, in any event, to separate out the specific consequences of policy changes from those of market-driven changes — and all the more so when policy changes are phased in over time. Indeed, in some circumstances, policy changes — such as those at the heart of the overall microeconomic reform agenda — are designed to reduce the costs and consequences of market-driven changes in global markets, including to those 'adversely' affected by specific measures.
 - Sequential policy-induced reforms imply that those who are relative losers at one stage can become relative winners at another (and vice versa). Even if you were inclined to compensate, you'd need to evaluate the whole sequence to determine appropriate compensation levels — or have a recoupment, as well as disbursement, mechanism.
 - The supply of compensation creates its own demand: it's easier to control demand when you've got the supply under firm control and, in particular, removed from the influence of the political pork-barrel (eg clear, unchanging, rules governing 'exceptional circumstances').

Interestingly, in the context of the SA Regional Development Task Force's consultations, there was widespread understanding that the stresses and strains regions were feeling couldn't be attributed to single causes, and widespread acceptance that globalisation and its consequences necessitated changes in policies and attitudes.

What the regions wanted was not, typically, to have the policies undone, or buckets of money poured into them in compensation but, rather, a better understanding of the compound regional consequences of market and policy changes and better communication and coordination between governments (and their agencies) and with the regions about the consequences of policy and market changes. More often than not, especially in non-capital city regions, the principal complaints were about the inadequacy of education, training and retraining services available to help to cope with the cumulative effect of changes; the low priority they received relative to the capital cities in spending on infrastructure networks (transport, power, water) adequate to allow them to exploit their (new) potential; and, especially, their concern about not getting access to the IT&T infrastructure and services that they saw as essential to their survival as competitive communities.

If regions were, in effect, asking for 'compensation' for the impacts of change, it was largely in these forms rather than via subsidies to attract industries. And their claims, which can be subjected to evaluation, were more about lack of *priority* for establishable needs than of the 'you owe us' variety.

One of the points to be made from this is that, if compensation or structural adjustment assistance were to be given in some agreed circumstances, it might best be delivered at region-wide level for agreed purposes supported by realistic strategic plans for the region, rather than to specific businesses or communities or groups of people directly affected by change. Improved education and training and retraining services would be a particularly valuable target for regional support.

Equally important, it seemed clear that it was the cumulative and/or confusing effects of repeated waves of reforms — intermingled, of course, with on-going changes in market conditions — that caused much community and regional stress. There was, moreover, much confusion and concern about the difference between transitional effects and the permanent effects of change.

Although it's not possible to start again, one lesson for the future from this would seem to be that sequential reform eventually leads to fatigue and resistance to further reforms, whereas a package of product and labour market reforms, plus financial, telecommunications and other service market reforms, plus public sector outsourcing and privatisation, implemented relatively rapidly might have eased the burden in the medium to long term, even if, possibly, at the expense of a more acute sense of dislocation initially.

This, of course, supports the claims of some — most vociferously, Roger Douglas — that the notions of 'speed limits' on, and 'optimal sequencing' of, reform are misconceived. To policy practitioners — as Douglas once was — the lesson learned is that you should grab any window of opportunity that opens to do as much as possible. To analysts, a theoretical underpinning for the break-through-on-all-fronts strategy would be that there would be much cross-cancelling of gains and losses to individuals and to powerful interest groups, reducing compensation pressures.

In my view, while packaging of reforms has much going for it in terms of reducing resistance to reforms, it's not clear that 'doing as much as you can all at once' is either practical or desirable. Causing confusion among people and businesses about the potential consequences of reforms doesn't seem to me to have much claim as either an ethically desirable approach to reforms, or as a way of building sustained counter-constituencies to the traditional entrenched interests.

As for distinguishing between transitional and permanent effects of change, there is real reason for confusion. Particular skills are declining (sometimes precipitously) in demand, and some of those with them may never reskill. This is likely to cause the sort of 'locational' concentration of economic and social decline that Hunter and Gregory (1995) have identified. But if education, training and retraining systems are as responsive as we hope they'll be, including giving priority to life-long learning,

there's no reason to suppose that current levels and patterns of unemployment are permanent. Change creates new opportunities as well as destroying old ones.

That said, much depends on ensuring that the social capital of communities and regions that are especially being disadvantaged by concentrated loss of jobs relevant to their skills is supported and strengthened: a serious concern is that economic and social exclusion become mutually reinforcing, and create 'black holes' from which the disadvantaged and their offspring can't escape.

To this point, I've ostensibly rejected the proposition that market-driven change and policy-induced change can and should be distinguished. However, I haven't stuck steadfastly to that claim. In particular, I've implicitly conceded that 'distributional' aspects of policy-induced change (reform) might need to be handled with some care.

What this reflects, of course, is that while, in principle, the distinction is often spurious and hard to sustain, in practice, there are some differences that need to be acknowledged. It's how to 'manage' them that's the key question.

The essence of the differences, of course, is that policy-induced changes result from transparent processes that often involve highly partisan debate among elected representatives of 'the people'. Even people not directly 'at risk' see themselves as legitimate participants in the debate about the consequences of reforms. Market decisions, by contrast, 'happen'. Even where there's a pre-announcement of them (eg a BHP closure or downsizing), the debate usually is about how and when (not whether), and is usually limited to the affected communities and executive governments, not legislatures and the wider nation.

The politics of policy change often exaggerates the potential implications of policy-induced changes relative to market changes. For example, deregulating Adelaide's taxi industry possibly would have less impact on wealth and activity in Adelaide than BHP's shutdown will on Newcastle. Yet the latter is happening, but the former appears very unlikely.

Given these differences, it's tempting to argue that compensation may be desirable in the case of policy-induced changes — essentially to 'oil-the-wheels' of reform where otherwise it might get blocked by the interaction of entrenched interests and partisan politics.

Observation suggests that this view is naive in several different senses.

The first is that, in practice, governments allow themselves to be partners in compensation even where market-driven changes of sufficient magnitude are

involved: both the New South Wales and Commonwealth governments have given \$10 million for ‘structural adjustment’ in the Hunter region for what is more of a psychological (or morale) problem than an economic one.

The second is that, even where policy-induced changes are clearly at the heart of political pressures, it’s not distributional equity that drives whether and how much compensation is paid, but rather the (potential) political clout of the affected groups. Faced with these realities, we have a range of possible options for policy advisers.

At one extreme is what might be called the ‘pure fatalist option’: that is, concede that compensation of some sort must be paid whenever political resistance makes the ‘heat in the policy kitchen’ too high to bear. The probable consequence would be that virtually all major reforms would be stalled because the costs of compensation would be prohibitive.

At the other extreme is the ‘no-compensation-in-any-circumstances’ response. The probable consequence of this is that some reform options of value would be missed, as a result of political resistance.

The question then is: is there not so much a ‘half-way-house’ as a ‘safe-house’ between these two extremes? My answer is extremely tentative, despite years of exposure at political advisory levels to variants of the question.

To explain this, I need to return, initially, to the ‘exceptional circumstances’ I referred to earlier.

To begin with, the Australian Constitution (but not, interestingly, state Constitutions) guarantees that there will be ‘just compensation’ for compulsory acquisition of property. How far this guarantee extends I haven’t investigated, but it’s clear that it involves all forms of ‘real estate’ — after all, a person’s home, or farm, is their castle!

There’s also a wide body of literature (of the public choice variety) that would suggest that the tax system has quasi-constitutional status. To this, I’d add the social welfare transfer system, because the central point is that, more obviously and directly than anything else in the policy-controlled world, the structure of the tax/welfare system determines how disposable incomes are distributed. One could, nowadays, perhaps add some other components relevant, more generally, to well-being, such as access to basic levels of education and health services irrespective of means, but the general point, I think, is clear: changes to the tax/transfer system need more than the usual degree of scrutiny, and, in principle, a preparedness to compensate losers for efficiency increasing changes — especially if the losers are on low-incomes, whether earned or unearned.

By the same token, with the tax/transfer system as a basic redistributive mechanism *cum* social safety net, it's not obvious that any other context appropriately should involve 'compensation' of losers from policy-induced changes — except that good regional policies, good lifelong education and training policies and much else besides would make coping with change much easier, regionally and in industry specific circumstances.

A serious complication in the Australian context, however, is that mobility of people (and businesses) in response to economic shocks appears to be very low. This view was supported by empirical work undertaken for the IC's *Impediments to Regional Industry Adjustment* inquiry referred to earlier. The American view that those who can't find work or adequate well-being where they currently live 'should be offered bus tickets to more viable locations' doesn't appear likely to be well-accepted in Australia. Are we willing and content for declining communities and regions to become gathering places for the 'excluded', or should we accept the reality of Australia's socio-economic underpinnings and agree that, ultimately, we have to 'take work to the potential workers'?

There's no simple, easy answer, but it seems to me that we have less to fear by way of moral hazard and supply creating its own demand in being willing to develop structural adjustment strategies for regions than we do from firm, industry, product or people specific compensation/adjustment approaches. This reflects a presumption that 'regional adjustment support' would or should be triggered by changes in aggregate regional trends over time, rather than specific market- or policy-induced impacts on sub-sectors of regional businesses and their workforces. It's unlikely that individual regional businesses or their workers would presume that they can influence the scale of regional support, in most circumstances, if it's dependent on aggregate trends such as relative unemployment rates, or trends in them and/or measures of regional social stresses. Moreover, this would be further strengthened if the level and type of support offered to regions was based on realistic long-term strategic plans for overall regional development or stabilisation. Providing buckets of money to support job creation, willy-nilly, is the least attractive option. When the money is spent, there's no guarantee — indeed, little likelihood — that anything by way of structural change will have occurred.

Finally, in relation to evaluation of the level(s) of compensation that appropriately might be paid in agreed circumstances, there are several tricky issues.

The first, and most important, relates to the dynamic circumstances of change. Two typical assumptions of modelling or other forms of assessment of the impacts of change — that it's appropriate to apply the *ceteris paribus* assumption, and that comparative static frameworks are adequate — are so obviously irrelevant to the

bulk of circumstances in which policy and market changes interact that (with the benefit of much hindsight) I'm amazed we've tolerated their application for so long. As I noted earlier, the habit of measuring only the one-off benefits of resource reallocation without attempting to assess the long-term impacts on innovation and growth is likely to be misleading — and biased towards trivialising the gains from change and reform.

A second issue is that, more often than not, information on the distributional impacts of reform isn't provided — or, if it is, it relates (again) to comparative static impacts on occupational or family types, rather than exploring the dynamic changes in opportunities that can either directly or indirectly be expected to affect the overall distribution of incomes and well-being. My gut feeling is that this, too, leaves market changes and associated reforms subject to misinterpretation and underevaluation.

A third issue is that, particularly in the case of policy-induced changes, the value attached to existing property rights is changed by the announcement effects of possible reforms, and the more so the closer a final decision among options is approached. At which point are 'values' to be evaluated? The simple nostrum that market-related values reliably identify (most) benefits and costs, in effect, finesses this question by ignoring it. Yet the way we answer it clearly can bias assessments of the consequences of change, including where distributional impacts are considered to be salient. My view is that, once potential change is 'announced' *original market values* have no practical or ethical evaluative relevance.

The difficulties associated with evaluation of the consequences of change, either for overall productivity and growth, or for distributional outcomes, isn't a good reason for not attempting to evaluate them. Policy decisions are likely to be improved by more — relevant — information. This is especially so with respect to *distributional* impacts — whether interpersonal or inter-sectoral — to diminish the political clout of usually well-off interest groups.

Current modelling and/or evaluation methodologies, however, are *not* guaranteed to give the right (qualitative, let alone quantitative) answers. Through their comparative statu content, they are likely to understate especially the potential benefits, but also the costs of change — whether market or policy induced.

Those who emphasise that we (now) live in a world in which change is endemic have a point. But not necessarily a decisive one. Unless or until we establish that there are consistent variations in how dynamic perspectives actually affect both benefits and costs, we are doomed to 'casual' judgements. The world of modelling should be, but currently is not, a source of informed judgement on these issues. The Productivity Commission, in my view, should be devoting much more of its

research effort to building dynamic modelling frameworks, which capture, in particular, the effects of reforms on innovations and technology transfer, than currently appears to be the case.

At the end of the day, however, the question of how to evaluate the implications of change and the impact, in particular, of specific policy initiatives doesn't have a clear answer, especially within existing evaluation and modelling methodologies. While this is a matter for regret, it's not, however, a disaster. The bottom-line remains that, in most circumstances, the 'no compensation' principle is the relevant guide. Our evaluation efforts should be concentrated on what are agreed to be exceptional circumstances.

The principles which should be applied to exceptional circumstances, however, are themselves debatable. We don't want to excessively or undesirably distort current and future choices as a result of recognising that distributional outcomes (sometimes) matter and trying to correct for them. Fred Argy (see, for example, in Argy 1996), has discussed these issues and I do not intend to retrace his steps.

7.9 Concluding remarks

The central thrust of this paper is that reform fatigue or resistance may be, in large measure, ultimately a result of a lack of an appropriate focus on regional policy. In turn, my claim is that that this results in a weak focus on social policy more generally, and in weak development and promotion of foundations for a new economic policy in an era of profound change in both how markets are impacting on society and how policy reforms are being formulated and promoted to respond to, or accommodate, this market-driven change.

I've suggested principles for a redesign of national regional policy that emphasise local leadership for community-based development, with the role of governments — local, state and Commonwealth — to support and work in partnership with communities and regions.

I don't claim that a strengthened focus on regional policy will entirely remove resistance to reforms and claims for compensation but, rather, that it has the potential to oil-the-wheels in ways which can reduce the incidence and the political salience of traditional industry or firm-based lobby activity for special treatment.

More generally, I support the view that compensation and structural adjustment should generally be restricted to truly exceptional circumstances such as would apply when (as in the case of tax reforms) economy-wide changes to the distribution of incomes are likely.

I also suggest, *inter alia*, that limiting compensation to supporting regions which meet broad criteria indicating relative economic and/or social stress might provide an approach which minimises the risk of moral hazard and or supply creating its own demand.

References

- Argy, F. 1996, 'Equity and efficiency: policy considerations', in Industry Commission, *Conference on Equity, Efficiency and Welfare, Melbourne, 1–2 November 1995*, AGPS, Canberra, pp. 67–97.
- Hunter, B. and Gregory, R.G. 1995, *The Macro Economy and the Growth of Ghettos and Urban Poverty in Australia*, Centre for Economic Policy Research paper no. 325, Australian National University, Canberra.
- IC (Industry Commission) 1993, *Impediments to Regional Industry Adjustment*, Report no. 35, AGPS, Canberra.
- Kelty Taskforce. *See* Taskforce on Regional Development 1993.
- Latham, M. 1998, *Civilizing Global Capital: New Thinking for Australian Labor*, Allen & Unwin, Sydney.
- MAV (Municipal Association of Victoria) 1994.
- McKinsey and Company 1994, *Lead Local Compete Global: Unlocking the Growth Potential for Australia's Regions*, Final Report for the Office of Regional Development, Department of Housing and Regional Development, Canberra.
- 1996, *Supporting Regional Leadership: Unfinished Business*, Report to Department of Transport and Regional Development, Canberra.
- Musgrave, R. 1959, *The Theory of Public Finance*, McGraw-Hill, New York.
- Olson, M. 1982, *The Rise and Decline of Nations: Economic Growth, Stagflation and Social Rigidities*, Yale University Press, USA.
- Tanner, L. 1999, *Open Australia*, Pluto Press, Australia.
- Taskforce on Regional Development 1993, *Developing Australia: A Regional Perspective*, A report to the Federal Government by the Taskforce on Regional Development (Bill Kelty chairman), AGPS, Canberra.

8 Structural change: objectives, evaluation and incentives

Peter Forsyth

8.1 Introduction

In discussing responses to structural change, it is appropriate to begin by examining the objectives which decision makers might have. There are distinct differences between the authors on objectives, and it is necessary to highlight and clarify the options. Here there will be particular attention paid to notions of fairness; fairness is an objective which many would regard as important, though none of the authors discuss it explicitly. This is not surprising, granted that it is not a concept which economists often use. Next, a distinction between compensation and adjustment assistance is drawn. These are two potentially separate policy responses to structural change, and they seek to address different issues — compensation primarily addresses equity and fairness aspects, whereas adjustment assistance seeks to lessen the costs of adjustment by addressing market failures. Finally, the question of whether there is a useful distinction to be made between policy-induced and market-based structural change is explored.

8.2 Evaluating structural change: determining the objectives

If structural change is to be evaluated, the objectives need to be set out. The normal framework within which economists work is that of efficiency and equity objectives. Economists will debate whether equity aspects of changes should be taken into account, and if they are, how this should be done. The emphasis on these two objectives will differ from economist to economist; some pay very little or no attention to equity aspects, whereas others include equity aspects quite explicitly in their evaluation process.

8.2.1 Efficiency and equity

Of the contributors, Kasper takes the strongest line on downplaying equity aspects in evaluating structural change. He emphasises efficiency, and a particular aspect of efficiency, in stressing its dynamic dimensions. Thus he advocates a growth maximisation approach, and downplays static notions of efficiency. He also takes the view that this aspect of efficiency is best promoted through reliance on market outcomes, with minimal government intervention. Walsh also tends to this position, though with an important exception (see the discussion of regional issues below), but he is less explicit about it.

It is important to recognise that the emphasis on growth or efficiency, and on market outcomes, do not necessarily always come together. It would be possible to emphasise efficiency yet mistrust market outcomes. Such a position would put emphasis on market failures, and it could lead to a presumption in favour of considerable government intervention. For example, someone holding this view might be in favour of adjustment assistance to correct the effects of market-based structural changes. A belief in significant external diseconomies in urban growth could lead one to advocate assistance to declining regions, to limit migration out of them. (Argy, while he does not ignore equity aspects, argues for responses to structural change based on market failure considerations.) Such a person might also argue that policy-based structural changes may be better if accompanied by incentives to adjust (for example, if tariffs are cut, workers should be given incentives to retrain). This recommendation would not be based on a desire to *compensate* workers on equity grounds, but a belief that they will undervalue the benefits of retraining, or that the market price of retraining exceeds its opportunity cost.

In contrast to the efficiency only position, Savage puts forward an objective which incorporates equity as well as efficiency. Argy and Gray also incorporate equity, though they are less explicit about how it should be included. Strictly speaking, in the public economics framework used by Savage, it is no longer possible to distinguish between ‘equity’ and ‘efficiency’. What matters is overall social welfare, which can be evaluated conceptually in terms of the Bergson Samuelson social welfare function. This aggregates weighted individual utilities, where the weights depend on circumstances such as income (and potentially other factors). In practice, governments, as representatives of society, do have preferences for equity (they may be more or less egalitarian) which are reflected in their decisions, such as their choices of tax schedules.

A change, be it resulting from a policy or an exogenous influence, can be evaluated in terms of its impact on social welfare. While the economic analyst does not have a

set of welfare weights, he or she provides the relevant information on who gains and loses to the government, which then can evaluate the change using its preferred weights. This approach has been strongly advocated at various times — for a while it was promoted by the World Bank, which supported the use of welfare weights in cost-benefit analysis (Ray 1984). The World Bank has since moved away from this position.

Each of these positions, the efficiency only and the equity and efficiency position, leads to a perspective on compensation for structural change and adjustment assistance.

If the efficiency only position is taken, there is no reason to compensate. Compensation is rarely costless, and it will detract from the gains from the change. This will be so regardless of whether the change is policy-induced or not. There may be arguments for or against compensation, but they rely on additional aspects, such as long term incentive effects (Kasper discusses them extensively). Under the efficiency only position, there may be an argument for adjustment assistance — this depends on the view taken on market failures. Such assistance will be of the form to give incentives to correct for market failures, and it will not be designed to compensate losers.

Under the equity and efficiency position, the issue of whether to compensate is a straightforward one. Compensation should be paid if it increases overall welfare; otherwise not. If a reform improves efficiency, welfare will only increase if the outcome is more egalitarian — this means that only the relatively poor should be compensated, not the relatively rich. Compensation will mean that a policy-induced change can improve welfare more, thus it can be desirable. It can also result in higher social welfare after a market-induced change, where it makes the outcome more egalitarian.

Again, within this framework, there may or may not be a case for adjustment assistance; this depends on the presence or otherwise of market failures. It is also possible to accept this framework but also consider other benefits and costs of compensation, such as those discussed by Argy, Gray and Kasper.

8.2.2 The uninvited guest — fairness or justice

Economists are uncomfortable with the notion of fairness or justice (here used interchangeably) but it not something which they can ignore. Others in society do have concepts of what is and is not fair, and they expect fairness to be taken account of when decisions are made. Such persons may indeed be involved in decision making, or they may be in a position to veto decisions they regard as unfair (for a

discussion of fairness in economics, see Zajac 1995). Of the contributors, none seems to identify a specific notion of fairness, though Argy uses the term fairness as an aspect of equity (p. 49). (Fairness is perhaps a concept applied more to the way a process is carried out than to the outcomes of the process, especially in the legal context.)

Fairness goes beyond equity, as the following example illustrates. Suppose a change which yields a big gain for the rich, but a small loss for the poor. Granted society's distributional preferences, it may be judged as welfare enhancing. However suppose that all the costs fall on a few, poor, people, who lose much relative to their wealth. Would such a change be regarded as desirable, or as fair? Often such a change would be rejected even though it is welfare enhancing according to the efficiency and equity criterion.

Notions of fairness influence the way in which institutions in society are structured. If the government resumes land to build a road, the result may be welfare enhancing even though no compensation may be paid. The road may produce large benefits compared to its cost, and if benefits are spread widely, but the land comes from someone who is relatively rich, welfare may rise. However many would regard resumption of land without compensation as being unfair — so much so that rights to compensation can even be written into a constitution. Property rights for assets such as land often include the right to compensation should those assets be acquired compulsorily by the government. It should be noted that governments can, and do, change the basis on which compensation will be paid; while most Australian governments use market values as the basis for compensation, in earlier times they often used artificial values which fell far below market values.

How far do these rights to compensation go? Some assets are essentially created by regulation — for example, the value of a taxi licence depends on how many taxi licences have been issued, and whether the number is arbitrarily constrained. Taxi deregulation may be desirable on equity and efficiency grounds, but it would result in big capital losses for those who currently hold licences. Such deregulation without compensation would be regarded by many as unfair. When eggs were deregulated in New South Wales, compensation was paid to egg producers. This may have been for reasons of political expediency because producers would have opposed change, but it may also have been seen as the fair thing to do. Egg deregulation has happened; taxi deregulation has not.

It is not easy to distinguish between the land and the licence cases. In the latter case, an asset has been created by an explicit regulatory policy of the government, and there need never have been a guarantee that the regulation would last for ever. On the other hand, the value of the land was very much conditional on the regulatory

environment governing the use of the land. The value of land depends on planning controls, on water rights and other regulatory factors.

While it is difficult for the economic analyst to incorporate equity when evaluating a change, it is even more difficult to allow for considerations of fairness. There are no generally accepted criteria of what is fair that can be drawn upon.

Nevertheless there are some observations that can be made. Where a change imposes a very large loss on an individual it will often be regarded as unfair. The same loss spread amongst many will be regarded as much fairer. Furthermore, attitudes differ between societies. Some societies may be much more willing than others to accept, without compensation, situations where individuals lose from structural change, be it market- or policy-induced. Australia is probably in the less willing category. This willingness can depend on experience; those societies which have been forced to change rapidly are likely to be less demanding of compensation. Attitudes towards market- and policy-induced change can differ; a society may be willing to accept losses from market-based change, because they are regarded as inevitable, but may regard policy-induced losses as being more unfair (because they could have been avoided).

Economic analysts need to be aware of fairness considerations, and to distinguish them from equity aspects. Many of the arrangements that we observe, especially those which organise compensation when individuals or groups lose from change, can be interpreted as promoting fairness, as understood by decision makers. Many structural changes will meet efficiency and equity tests, but will still be opposed on fairness grounds. While economists themselves may not determine what fairness is, they do have a role in designing alterations to policies so as to minimise the cost in terms of equity and efficiency of meeting the constraints of fairness.

8.2.3 Special groups and regions

One issue which needs to be addressed is whether the aspects discussed so far (equity, efficiency and fairness) encompass all the objectives, or whether special attention should be paid to specific groups, such as regions or indigenous groups. If the former is the case, all policy issues can be analysed with no reference to the specified group, such as the region. There will be no regional policy as such, though particular structural changes, adjustment incentives and compensatory mechanisms will have effects in regions.

Alternatively, groups such as regions may be given special status in terms of society's objectives. Preservation of regions may be regarded by some as desirable for its own sake, as Walsh (p. 206) and Argy (p. 62) seem to argue. If closing an

industry in a region leads to the decline of that region, should we care? If we do, the range of responses differs from when we do not. For example, those who lose from closure may be able to be compensated by cash handouts. However, if they receive these, they may leave the region and head for the city. The same could happen if there is general adjustment assistance. If regions are to be valued per se, the best response would be to grant specific incentives for further economic activity in the region, as is canvassed by Walsh.

The fact that Australia is not simply a single unified jurisdiction suggests that some regional differences should be allowed for. There are separate states, with separate governments, and these governments have differing objectives. At a further level, there are separate local governments, with authority over some economic activity, and which differ in terms of objectives amongst themselves. However, if these regionally based distinctions are drawn appropriately, is it necessary for governments to treat different regions within their boundaries differently? The existence of policies which differentiate between regions within their jurisdictions is testament that they do. As economic analysts, we may have to recognise that decision makers do put a special value on the preservation of regions (though it is still appropriate for analysts to question this).

8.3 Compensation and adjustment assistance

It is useful to make a distinction, which none of the authors make very clear, between the notions of compensation and adjustment assistance. Compensation is a payment which is made to the loser from a change designed to restore them to the real income position they enjoyed in the absence of the change. In price theory, we speak of the compensating variation of a price change which restores the real income of the individual to the previous level. The simplest form of compensation is a cash transfer; this form has no allocative implications in that it does not induce the recipient to change their behaviour. Compensation can be paid in kind; where there is a market for the good or service used for compensation, there need be no incentive effects since the recipient can convert the compensation into cash and spend it as they will. Where such a market does not exist, compensation in kind can influence consumption choices, and it can be less valuable for this reason. Finally, compensation can take the form of incentives, which if acted upon, have the potential to increase the recipient's real income. Thus a person might be compensated for a tax increase by being given the opportunity to buy cheap, subsidised food. Consumption behaviour will normally be altered, and the value of the compensation will depend on the response to the price change. If the objective of the compensation is simply to restore the person to the previous income level, the most efficient form is cash.

Adjustment assistance combines both compensation and incentives to change behaviour. Thus workers in a declining region may be offered subsidised opportunities to retrain, or to shift to where there are more jobs available. Such assistance will have the effect of increasing the real income of those who take advantage of the incentives. However, it will also change their behaviour. If all price signals were correct before, such incentives would be inefficient, as simple cash compensation would be preferable.

Thus a case has to be made for adjustment assistance which takes the form of giving incentives to alter behaviour. One might be made in terms of market failures; it could be that market signals are distorted, and specific encouragement must be given to parties affected by the policy change to adjust efficiently. For example, perhaps displaced workers underestimate the benefits of retraining. Another example would be where people are given incentives to stay in a region rather than move to a city where there are external diseconomies of further urban expansion. In each situation the case for the intervention should be made; ideally, the intervention would be the best feasible response to the identified market failure. If adjustment assistance efficiently corrects for market failures it will reduce the costs of adjustment.

It is also possible that adjustment assistance takes the form of a screening device to limit the extent of compensation. Assistance might take the form of a training incentive, which requires an effort on the part of the recipient. Compensation may be limited to those who are prepared to help themselves. Such conditional compensation may be less destructive of incentives to put in effort than open ended compensation.

There is a real danger that adjustment assistance may end up being a reasonable sounding but inefficient form of compensation. It may encourage affected parties to exert efforts in ways which they would not choose to do, for little long term gain. Thus retraining may seem appropriate, but there must be jobs at the end of the process. If there are not, time and resources will have been wasted.

It is worth noting that the two elements — compensation and incentives to adjust — are, in principle and practice, quite separable. If there is a desire to grant compensation, but there is no desire to alter behaviour, then direct cash compensation granted to parties who lose from a policy change is the preferable option. Alternatively, if there is no willingness to grant compensation, for the reasons canvassed in several of the papers (especially Argy), but there is a belief that market failures are present, adjustment incentives can be implemented which do not embody a compensation element. Sticks can be used as well as carrots.

8.4 Should policy-induced and market-based structural change be treated differently?

One issue raised by several authors is whether policy-induced and market-based changes can be distinguished. Some such as Kasper claim that they cannot. This is an extraordinary position to take. It is one thing to note that it may often be difficult to distinguish the two, and that many changes may involve a combination of both elements. However, very often the two can be distinguished very clearly. The decision to build the Citylink expressway in Melbourne was a policy decision which could have been made differently; it was hardly the inevitable consequence of globalisation or some other market-based change affecting the economy. A government which resumes land (with or without compensation) for the project can hardly claim that it is not responsible for it.

8.4.1 Political decisions and change

Granted this, there is an important practical distinction between market-based and policy-based changes. The latter require political decisions for them to go ahead; the former do not. These political decisions require support; this may be achieved by compensating losers from the change, something which could be essential when the losers are in a position to veto the change. Whether compensation is paid or not may determine whether the change happens or not. This is not the case with market-based changes which will happen regardless of whether losers are compensated.

This may be regarded by some such as Kasper as political expediency, who oppose the payment of compensation as a means of achieving approval for change (p. 143). There may be benefits and costs from paying compensation in this way — Kasper provides a litany of the costs. However, it may be the way things are done. When he discusses the problems of paying compensation, Kasper seems to take a perspective of the government which is more akin to the public economics view of the government as a benevolent custodian of the public interest than the public choice view, which sees the government as a player amongst others, influenced by powerful interests. In this latter world, structural change will only come about if governments are able to gather support for them, and doing this may necessitate eliminating opposition from losers by paying them compensation.

Market-based changes will happen, and no political decisions will be needed to bring them into being. Political decisions will be needed if compensation is to be paid. Granted that political decisions have a cost, such compensation will be made less likely. Thus a critical distinction between market- and policy-based change is

that political inertia increases the likelihood of compensation in the latter case, but decreases it in the former.

8.4.2 Commitments to compensate

Another important way in which market-based structural changes differ from policy-induced changes is that with the latter there can be a prior commitment to compensate. In theory, it might be possible for a government to commit to compensation for losses due to market changes, but this would be difficult, and there are rarely strong reasons for doing so. By contrast, governments may have good reasons for committing to compensation if policies change.

Governments can, and do, promise compensation should they change their policies, and sometimes they lock themselves in by contracting to pay compensation. Thus, in Victoria, the state government has contracted to compensate the private developers of the Citylink toll road should it make transport investments which reduce the demand for the toll road. When there is a contract, the government will have to pay compensation, and where the government has promised to pay, it will be under strong pressure to live up to its promise, even though it can renege on its promise. Governments can and sometimes behave opportunistically, but they recognise that this entails the cost of reduced credibility for the future.

Thus contracts are a useful form of commitment, and keeping promises is a useful means of establishing credibility. Governments often choose to lock themselves in, or to make promises. This has the advantage of assuring investors and risk takers that they will not behave opportunistically, however well intended such behaviour might be. Governments realise they can advance their objectives, such as a rapidly growing economy, by establishing a consistent policy framework. This can be illustrated by considering those governments which have failed to do so. In several economies (notably some transition economies) the policies of governments are seen as erratic, and sometimes opportunistic. Governments make no commitments to preserving the economic environment. As a result firms are hesitant to invest, and will only do so if rates of return are very high.

The question does arise of just how far a government should go in making commitments in advance to compensate should it change its policy direction. There can be benefits, as suggested above. There are also costs. By committing, the government rules itself out of making policy changes which may be desirable once circumstances have changed. It can have locked itself into a less than optimal response. One cost, often considered to be associated with compensation, that of rent seeking, should not be present, however. This is because the conditions under which compensation will be paid are set out clearly beforehand, and rent seeking

behaviour will not be capable of increasing the likelihood of compensation if contracts are well designed. However, with ill specified contracts there can be information asymmetries and there will be attempts to exaggerate the losses.

References

Ray, A. 1984, *Cost-Benefit Analysis: Issues and Methodologies*, Johns Hopkins Press, Baltimore.

Zajak, E. 1995, *Political Economy of Fairness*, MIT Press, Cambridge, USA.

9 Evaluating policy changes: the economic and social dimensions

Glenn Withers

9.1 Introduction

I would like to start by congratulating the Productivity Commission for organising this workshop. With more initiatives of this kind the Commission will be in serious danger of appearing balanced — and that is dangerous because I am a great believer in J.S. Mill’s aphorism that the virtue of extremism is that it makes moderate reform seem feasible (Mill 1863).

Be that as it may, this is an important topic and our commissioned contributors have all made commendable efforts to grapple with the problems. But in the end, and despite some progress, they have failed: structural adjustment, to my mind, remains a category of ad hoc policy measures still searching for an analytical framework.

There is therefore disappointment in these efforts — but there is also promise. Let me address these two aspects in turn.

9.2 Disappointment

Disappointment arises because the papers from a most talented and capable representative group from the profession, do make clear that the Emperor has no clothes:

- a) ask five economists the same question and you get seven answers — three of them today from Malcolm Gray.
- b) the dominant neoclassical paradigm is exposed as still being congenitally incapable of:
 - (i) being specific beyond time-hallowed but weak ethical prescriptions based on Paretian or potential compensation criteria;
 - (ii) expressing dynamic adjustment properties rather than comparative static (or, occasionally, equilibrium growth path) propositions; and

-
- (iii) centrally incorporating positive analysis of collective decision-making mechanisms as opposed to only market mechanisms.
- c) there seems to be a fair bit of rhetoric and generalities available on these issues, but precious little by way of hard empirical or even case study analysis on offer (some brief and conflicting aggregate growth econometrics aside).

Each of these points could be elaborated, but the general conclusion is that, in matters of structural adjustment, economists have a lot of trouble not looking like idiots savants. Perhaps the Productivity Commission could have, in this workshop, violated its evident internal rule which states that: ‘we only hire economists’. A few ethicists, social psychologists, or even political scientists might have added something newer. Even if they could not, it would be nice to have the company, so that nakedness of other disciplines would be equally exposed and the sniping could cease a little.

The point that I do wish to elaborate is that the lack of attention to dynamics (except for Wolfgang Kasper’s Austrian invocations) has meant that the contributors have focussed on distributional consequences of reform but ignored adjustment costs per se. To put this another way, adjustment costs are simply interpreted as equal to or a subset of equity or distributional concerns but not as part of the efficiency calculus itself.

Yet to put real time on the adjustment path can be a crucial calculation in efficiency terms for any reform where a meaningful discount rate is used. A further step is to know what that adjustment path looks like. Conventional econometrics simply imposes an arbitrary lag to allow for this — whether in estimation or simulation — or ignores it altogether and assumes equilibrium. Little resort is had to the core theory of adjustment (eg Hamermesh 1987) or to direct case analysis of adjustments: there is scope for more rigorous empirical analysis here and work such as that by Neil Ferry (1996) on tariffs provides an econometric start, and that of David Johnson (1993) on privatisation provides a case study example. And an underlying unanswered question is: are outcomes path dependent?

The long tails of poor performance that lag behind best practice for many years after reform (eg McKinsey and Company 1993) means that quantification and, even more, understanding of the dissemination process is of the essence for enhancing benefits from reform. Serious sustained empirical research on the positive economics (and social psychology and organisational analysis) of adjustment processes should be an absolute priority. And, in policy terms, these may lead to better facilitative measures, if not compensation policies per se. This distinction could be further generalised to distinguish compensation measures (based on equity criteria) from adjustment assistance (based on market failure criteria).

Let me also address briefly the issues of ethical evaluative criteria (also see Stiglitz 1988, ch. 4) and the absence of positive economics of public decision-making (eg Mueller 1989). Three predominant ethical criteria are implicit in the commissioned papers:

- a) libertarian, as in Kasper, and philosophically associated with say Nozick (1974);
- b) utilitarian, as in Gray, and philosophically associated with Bentham (Bowring 1838); and
- c) contractarian, as in Argy, and philosophically associated with Rawls (1971).

As Elizabeth Savage might say, these criteria are all in fact operational and when integrated with tax/transfer incentive effects can be explicitly analysed in policy design. Indeed in the optimal taxation literature this has been the main form of discourse. But it may miss the point. As Cooter and Helpmann (1974) showed empirically long ago, the welfare function actually maximized in observed tax levels and structures is more likely to be in practice the maximization of the utility of the median voter (rather than maximization of aggregate utility, or utility per capita or utility of the least advantaged, as would be required by various ethical criteria outlined above).

Knowledge of collective choice therefore matters as much as knowledge of market choice. Our commissioned papers acknowledge this from time to time by reference to the evils of rent-seeking, but basically good old-fashioned normative invocations dominate: ‘they oughta...’. Construction of how to assist the political system to deliver is limited and we are left with our economic pearls cast before the swine. The recent debacle in Senate Committee hearings over economic modelling and the GST shows that the profession needs a serious re-think over economic communication at the very least.

9.3 Promise

On the promising side of this review of structural adjustment, as indicated it is good that the topic is being addressed. Indeed I am not even concerned that there are five plus different views because really I agree with them all.

I agree that the Australian Settlement (Kelly 1994) and the associated Worker Welfare State (Castles 1989), while possibly even noble in purpose, cosseted Australia and diminished its vitality progressively over time. The reform process, especially since the 1980s, has re-integrated Australia globally and opened up much of the economy to needed flexibility and competition. Along the way we have constructed a relatively effective and economical system of social support, based

primarily upon means-tested flat rate benefits, categorical access, compulsory superannuation and medicare.

The result has been:

- a) a turnaround in productivity growth from half the OECD average to double the OECD average, and this, plus a floating exchange rate and fiscal consolidation, explains our current good macro performance (IC 1997); and
- b) conversion of rising market income inequality into improved equality for the least advantaged, after taxes/transfers and the social wage (Harding 1997).

These are strong outcomes and, while boasting of being the ‘strong man of Asia’ in 1999, risks hubris of the kind that brought ‘bringing home the bacon’ to a grinding halt after 1989, there are grounds for satisfaction and for believing that the ‘Third Way’ has been operating well here for the last 15 years.

Of course there is:

- a) continuing high unemployment — mostly the product of macro policy error in 1982-83 and 1990-91 and unduly conservative macro policy since (Argy 1998); and
- b) stress and uncertainty — perhaps in substantial part due to the unemployment (Wooden 1999).

These need to be addressed and a combination of macro, labour market, and work-welfare measures can assist, as can better political communication. There is also a need for continuing micro-reform as its productivity benefits have lowered the speed limits to expansion, and there are still important old and new areas to be tackled through such reform (PC 1996). These may even include serious reform of the institutions of public governance themselves.

I could also be convinced to agree that this process could be improved by better development of distributional information and adjustment efficiency-cost information, to enrich comparative statics presumptions. And that such information — with some weight to the lesser advantaged while keeping an eye on the median voters’ tolerance to forestall ‘downwards envy’ — could be used to assess policy proposals that exceed certain Gray-Argy thresholds. This should be part of a policy calculus — much as exists now under the public interest benefit provisions of the National Competition Policy legislative review process, applied further to tax and expenditure policies. And as Elizabeth Savage emphasises, the need to consider alternative instruments in this process is paramount. But I am less convinced of the consequent need for specific compensation, for adverse incentive and rent-seeking

reasons. And I am even less convinced that group equity rather than individual need is the right vehicle for ex post general welfare support (Latham 1998).

On these issues perhaps the circuit breaker in ensuring co-operation with reform, in the absence of specific or group compensation, is to return in the first instance to the notion of adjustment assistance and not automatically reach for compensation per se: tackle market failure before addressing equity.

If there is nevertheless to be compensation, then it is necessary to meet the argument that if you compensate for policy changes, you should equally compensate for market changes. The difference to my mind is that policy changes are deliberate, clear and transparent decisions of elected individuals explicitly accountable to the public and making decisions on behalf of the community. Market decisions are totally decentralised, indirect and diffuse. Indeed this is a virtue of markets: there is no-one to blame. To take an analogy, adverse change resulting from policy is ‘murder’, that from the market is ‘manslaughter’. The former can therefore have a different moral and practical rationale to justify compensation.

That said it also seems to me that the compensation for policy redress need not be universal. I suspect most people think that fairness means that compensation is appropriate for ‘innocent victims’ of policy change where the outcome of a deliberate decision of government threatens their livelihood and that this is not amenable to alternative adjustment assistance (ie Joe Bloggs should be looked after, Kerry Packer knew the risks).

The worry over treating all consequences of change equally then can be overcome. It involves a concern for socially just outcomes as well as for procedural justice. And it involves the further key elements of: ‘innocent victims’, ‘satiety’ and ‘cognitive dissonance’. People could not have reasonably allowed for the policy change. Even then, those of concern are only the least advantaged, who are of concern to us because of diminishing marginal utility of income, and high psychic cost of adverse change. Hence, incidentally, we can also forget the furphy of compensation for non-change.

There does remain the problem of recognising the adverse incentive effects of compensation. To deal with this we need to:

- design packages/logrolling to get offsetting benefits;
- design adjustment assistance directed at new maintenance of livelihood (using phasing of change, skill focus, information);
- design generic adjustment assistance to meet market failure in adjustment to change, but add tailored packages for area or community-specific focus of disadvantage (eg the La Trobe Valley and aborigines);

-
- leave compensation to the safety net (or the Constitution in relation to procedural justice) and seek to make compensation conditional (mutual obligation) and rule-based (contract state not nanny state); and
 - ensure that the adjustment and compensation provisions are fair and appropriate to underpin a continued electoral support based on willing compassion, avoiding envy and resentment. A dose of good political leadership can help here also.

All of this would be valuable.

9.4 The fourth way

But what do we then do for an encore? This is crucial, since I think the prescriptions from Argy, Savage and Gray are ‘Third Way’ prescriptions (Giddens 1994, 1998) and they are none the less worthy for that in rejecting old policy based on cosseting and for instead blending the merits of competition with caring, perhaps in the manner specified above. But the micro-reform that has made this possible has built-in limits. It involves productivity growth by shake-out: reallocating resources and eliminating inefficiency. These are once and for all gains and carry no promise for sustainable growth into the future.

There is therefore need for what I might call a ‘Fourth Way’, which is where Kasper and Walsh come in. Yes we need to move beyond neoclassical growth theory and its emphasis on input quantities and exogenous technology, and embrace endogenous growth with its emphasis on investing in quality infrastructure, human capital, plant and equipment, and also social capital and infrastructure. This means embracing global integration and competition and the knowledge economy, while offering an efficient social compact of:

- a) safety net compensation for change; and
- b) pro-active development of national capability for competition.

The relevant new theme is capability-building: it includes entrepreneurship and knowledge, and the institutions for these, but it also includes skills and capital formation and it recognises the centrality of spillovers in these areas and hence it mandates a key ongoing role for government. Such an approach breaks the equity/efficiency trade-off inherent in the Elizabeth Savage presentation and instead supports policies that enhance both.

Incidentally, just as neoclassical long-run computable general equilibrium models (Murphy, Orani etc) can, and should, be augmented for short run Keynesian properties and linked to distributional models (for groups and individuals), such as

those of NATSEM, so they can be expanded, in my view, for endogenous growth. For instance, Simon's rule on knowledge creation in manufacturing is that productivity goes up roughly with the square root of output, ie if you quadruple the size of an industry in an advanced economy, you may expect to double the output per worker (Simon 1986). This reflects a whole range of specialisation, scale and scope economies and learning by doing effects.

A good example of how this capability building might operate is the recent British policy statement 'Our Competitive Future' (UK Department of Trade and Industry, 1998). It is both conceptually clear and full of hands-on detail of how policy delivers on such policies, eg how do we create entrepreneurs? It is also very strong, in terms echoed in Cliff Walsh's paper at this workshop, on including collaborative support in capability building, including via regional policy. This does not discard Third Way gains, it improves upon them. They are the platform for the next stage. This is also the real way forward for the Productivity Commission's focus — finally delivering on John Dawkins' vision, not simply doing an EPAC and putting a human face on rationalism. If the Commission does not take this next step as well, I predict that policy ascendancy in the medium term will steadily shift to DISR/DETYA, leaving Treasury and the Productivity Commission and the National Competition Council well behind. This symposium indicates that the Commission at least may be open to the new ideas necessary for securing our longer-term future and its own.

References

- Argy, F. 1998, *Australia at the Crossroads: Radical Free Market or a Progressive Liberalism?*, Allen & Unwin, Sydney.
- Bowring, J. (ed), 1838, *The Works of Jeremy Bentham*, London.
- Castles, F. 1989, 'Social protection by other means', in Castles, F. (ed), *Comparative History of Public Policy*, Polity Press, Cambridge, UK.
- Cooter, R. and Helpman, E. 1974, 'Optimal taxation for transfer payments under different social welfare criteria', *Quarterly Journal of Economics*, November, pp. 656–70.
- Ferry, N. 1996, *Tariff Reform and Economic Growth*, EPAC Commission Paper, no. 10, AGPS, Canberra.
- Giddens, A. 1994, *Beyond Left and Right*, Polity Press, Cambridge.
- 1998, *The Third Way: The Renewal of Social Democracy*, Polity Press Cambridge.

-
- Hamermesh, D. 1987, 'The costs of worker displacement', *Quarterly Journal of Economics*, vol. 102, pp. 51–75.
- Harding, A. 1997, *The Suffering Middle: Trends in Income Inequality in Australia 1982-83 to 1993-94*, Discussion Paper no. 21, NATSEM, University of Canberra.
- IC (Industry Commission) 1997, *Assessing Australia's Productivity Performance*, AGPS, Canberra.
- Johnson, D. 1993, 'Some issues concerning the restructure of Australian Government business enterprises' in EPAC, *Issues in Competition Policy*, Background Paper no. 32, AGPS, Canberra, pp. 106–42.
- , Manning, I. and Hellwig, O. 1995, *Trends in the Distribution of Cash Income and Non-cash Benefits*, Department of Prime Minister and Cabinet, AGPS, Canberra.
- Kelly, P. 1994, *The End of Certainty: Power, Politics and Business in Australia*, Revised Edition, Allen & Unwin, Sydney.
- Latham, M. 1998, *Civilising Global Capital*, Allen and Unwin, Sydney.
- McKinsey & Company 1993, *The Challenge of Leadership: Australian Emerging High Value-Added Manufacturing Exporters*, Australian Manufacturing Council, Melbourne.
- Mill, J.S. 1863, *Utilitarianism*, London.
- Mueller, D. 1989, *Public Choice II*, Cambridge University Press, UK.
- Nozick, R. 1974, *Anarchy, State and Utopia*, Basic Books, New York.
- PC (Productivity Commission) 1996, *Stocktake of Progress in Microeconomic Reform*, AGPS, Canberra.
- Rawls, J. 1971, *A Theory of Justice*, Harvard University Press, Cambridge, Mass.
- Simon, J. 1986, *Theory of Population and Economic Growth*, Blackwell, New York.
- Stiglitz, J. 1988, *Economics of the Public Sector*, 2nd ed., Norton, New York.
- UK Department of Trade and Industry 1998, *Our Competitive Future: Building the Knowledge Driven Economy*, Department of Trade and Industry, London.
- Wooden, M. 1999, 'Job insecurity: getting the facts straighter', *Business Council of Australia papers*, vol. 1, no. 1, May, pp. 14–18.

10 Delivering effective adjustment assistance

Peter Saunders

10.1 General observations

First of all, let me say how much I enjoyed reading the five papers commissioned for this workshop. They cover a very broad range of issues from a many different perspectives. In terms of basic approach, the papers differ from the ‘welfare economics fundamentalism’ of Liz Savage to the ‘born again community development perspective’ of Cliff Walsh, to Fred Argy’s ‘modest egalitarianism’, to Wolfgang Kasper’s ‘growth fetishism’. Something for everyone in this menu!

Despite these differences, there are some broad areas of agreement in the papers, but also some very stark contrasts in the approaches taken, the identification of which issues are most important, the goals articulated and, above all, the values (explicit and implicit) of the authors.

Taken together, the papers do not reflect well on the ability of economists to provide useful and non-controversial advice to government on these important distributional questions. In part, this reflects the nature of the beast. Value judgements have no respect for consensus — although we ought to be able to agree on *where* judgements are needed and *about what*. Overall, it seemed to me that the differences in the papers went beyond what might normally be expected to result from applying different values to an agreed analytical framework and an established body of scientific knowledge.

I was also struck by the contrast between the theoretical sophistication with which the papers handled questions of efficiency and growth and the rather simplified (naive is probably a more accurate description) of their handling of some of the issues of inequality and redistribution, although Liz Savage’s paper is a notable exception in this regard.

I also found the language used in some of the papers quite revealing. Both Malcolm Gray and Wolfgang Kasper are guilty, in my view, of using value-laden

terminology. An example is Gray's description of policies that give greater emphasis to social and distributional issues as 'conservative' as compared with his description of efficiency-promoting reforms as 'worthwhile'. Wolfgang Kasper rejects the efficiency/equity paradigm in favour of visions reflecting 'reactionary-collectivist' and 'dynamist-individualist' attitudes. Use of this kind of language does little to elucidate the underlying issues and even less to promote reasoned debate on what are legitimate differences about the ranking of alternative policy outcomes.

It is also important to emphasise that the use of terms such as 'conservative' or 'reactionary' largely reflects the way in which public discussion of distributional or compensation issues have been scheduled into the broader policy agenda. Because distributional consequences are normally seen as an add-on to the 'real' issues of efficiency and growth, at least when discussing structural adjustment, they tend to be couched in terms of variations from the status quo. This has the effect that, by treating the status quo as the counterfactual against which change is evaluated (as is implied in Fred Argy's 'social smoothing' approach), those who wish to debate distributional matters are characterised as reactionary or conservative and, what is worse, as wanting to obstruct or subvert economic reforms that are 'in the community interest' in favour of maintaining the existing position. From here, it is a short step towards arguing that self-interest and the maintenance of (unjustified) privilege are the underlying motivations. This ploy has been used very effectively to undermine the case for giving more emphasis to distributional questions by those who support structural change.

This issue also raises a more fundamental analytical question relating to the choice of counterfactual. Without an assumed counterfactual, it is not possible to assess and analyse the distributional effects of policy reforms. At the same time, the choice of which counterfactual to use has a very important — often decisive — impact on how those effects are estimated and interpreted. Although this issue is addressed in several of the papers, I thought that it warranted a more thorough and systematic treatment.

On the face of it, use of the prevailing situation as the counterfactual has the advantage of simplicity. Even here, however, matters can quickly become rather complicated — as became clear at the end of the Senate GST hearings when the question arose of whether compensation should be over and above the existing commitment to keep the pension at 25 per cent of male total average weekly earnings or be subsumed within it. It was eventually acknowledged that the 25 per cent promise was part of current policy, although it took a while to get there and the point could well have been submerged.

This discussion also highlights the limitations of trying to consider the distributional consequences of structural change as an ‘add-on’, not really part of the ‘main game’. Here, I am in total agreement with Liz Savage and Cliff Walsh (who, incidentally arrive at the same conclusion from very different starting points) that since the correct emphasis should be on community well-being (or social welfare), distributional questions have to be seen as an *integral* part of policy and built in from the design stage — as part of the product not just part of the sales drive.

Is it unrealistic to hope that we can go beyond considering the equity of incremental changes from the distributional status quo to a more thorough ‘blue skies’ investigation of what we mean by equity in relation to income distribution? Is Fred Argy’s ‘social smoothing’ form of status quo egalitarianism the most that we can practically expect? I hope not. An important point to note in this context, is that if we are concerned solely with compensating those on low incomes adversely affected by structural reforms, then that in itself will apply an implicit endorsement of increased inequality if the reforms generate positive net benefits overall.

There is much in Liz Savage’s paper that points to how inequality research has made such issues more analytically manageable than they were 30 years ago and we are now better placed to address these kinds of questions at the stage at which policy is being developed and designed.

The main theme of Fred Argy’s paper is that: ‘if the right instruments are used, social smoothing can be effectively implemented’ (p. 51). In other words, correcting the adverse distributional effects of structural change *should* be done and *can* be done. I want to structure the rest of my comments around these two key ideas.

10.2 Redistribution as a policy objective

Although the focus of this workshop is on compensation, I have already argued that this is far too narrow a perspective, and one that has an in-built bias working against those who wish to promote the case for assessing the effectiveness of structural reform (and other) policies in terms of their equity impact measured against a distributional benchmark.

Although most of the papers give consideration to what kind of distributional outcome is most desirable, I was surprised at how little attention this issue received and at how shallow some of discussion was. The papers provide ample evidence to support the view that economists are not comfortable when dealing with equity and distributional questions.

The papers by Argy and Savage contain the most detailed discussion of distributional objectives, raising familiar issues to do with how best to measure economic resources (income or expenditure?), whether and how the measure should be adjusted using an equivalence scale (to reflect differing needs), what is the appropriate unit of analysis (the individual, family or household?) and whether the goal should be to equalise outcomes or opportunities?

Although Fred Argy's paper contains the most detailed discussion of these issues, I found the presentation at times somewhat confusing. Having claimed (on p. 42) that equity is concerned with 'making consumption more equal across the population' the paper argues (pp. 53-54) that, because the existence of inequalities reduces receptiveness to change and can lead to an under-investment in human capital by the poor, there are clear economic benefits to be gained by engaging in long-term *ex post* social smoothing. Yet, at the same time, it is claimed that wide income and wealth disparities 'are inconsistent with a level playing field and, hence, with competitive neutrality in the market place'. Surely, if there is any value in the notion of a 'level playing field' it is relation to equalising *ex ante* opportunities, rather than *ex post* outcomes? A level the field is designed to give both sides (or all players) an equal chance of winning, not to guarantee a drawn game or dead heat finish. It is a form of egalitarianism concerned with opportunities not outcomes, yet social smoothing is very much outcome-focused. There are, of course, limits to how an *ex ante* approach can be applied in practice and it is possible to view *ex post* social smoothing as the best that can actually be achieved.

The development of adequate compensation measures requires two questions to be answered: first, who are the losers? And second, how is their loss to be defined? Both have fundamental implications for the design and structure of the compensation package itself. Liz Savage is correct to emphasise the conceptual difficulties and practical implications surrounding the measurement of income. In order to illustrate the practical significance of these issues, the following example is drawn from unit record data from the 1993-94 *Household Expenditure Survey* (HES).

If households are ranked by their incomes and then by their expenditures and the two rankings are compared, only just over half (51.5 per cent) of those in the lowest income quintile are also in the lowest expenditure quintile, while almost 14 per cent of those in the lowest income quintile fall in the *top two* expenditure quintiles. A similar pattern emerges if we cross-classify the rankings in the other direction, where almost 20 per cent of households in the lowest expenditure quintile have incomes that place them in the top 40 per cent of the household income distribution.

Although these figures make no allowance for how differences in household size influence incomes and expenditures, the mis-match actually increases slightly if recorded income and expenditure are adjusted using a simple equivalence scale (equal to the square root of household size).

One obvious explanation of these results is that they are based on a snapshot and take no account of life-cycle effects; older households may be financing relatively high levels of consumption from relatively low incomes by dis-saving previously accumulated assets. However, when the above analysis (with the equivalence adjustment) is repeated for non-aged households only, the mis-match between income and expenditure rankings increases even further; now only about one-quarter (27 per cent) of those in the lowest income quintile are also in the lowest expenditure quintile.

I don't want to make too much of these results, other than to make the point that providing compensation for structural reforms (or compensating those who are made worse off) first involves identifying who these people are. This is by no means a straightforward exercise, in part because of data limitations, but also because of issues concerned with identifying who loses, and on what basis their loss is calculated.

These kinds of issues become considerably more complex once one adopts a dynamic perspective on the compensation question. There has been an increased tendency in recent years to introduce policies that affect incentive structures in ways designed to produce beneficial effects over the longer-term. For example, the *Working Nation* changes to the social security income test which combined a reduction in the free area with a lowering of the withdrawal rate had the effect of lowering the incomes of those with incomes slightly above the existing free area (Bradbury, 1994). The intention was that the lower benefit taper would increase the incentive to work so that, over the longer-run, the incomes of those adversely affected in the short-run would increase as they were induced to work more. Clearly, in such a case, there would be no sense in providing compensation for the *short-run* income loss, as this would be counter to the *longer-run* aims of the reform. How are we to distinguish in practice between these kinds of cases and those where compensation is justified?

Cliff Walsh takes a somewhat different approach to the compensation issue, focusing not on trying to compensate individuals and families, but on the need to consider the compensation question in relation to regional development. There is a lot of good sense and practical wisdom in this paper and I fully agree with his diagnosis of the 'social policy vacuum' that has resulted from the deregulation of a centralised wage determination system that lies at the heart of what Frank Castles

has termed the ‘wage earners’ welfare state’ (Castles, 1985), or what others have referred to as ‘the Australian social policy settlement’.

The central issue here is how to maintain support for the current system of means-tested (and some would say, mean-spirited) social security benefits against a background of an increasingly deregulated labour market in which wages can no longer be relied upon to provide the basis for an adequate living wage for families?

I also thought that Cliff Walsh’s ‘exceptional circumstances’ rule provides a potentially useful vehicle for advancing debate on compensation issues in the context of the underlying goals of redistribution and equity, even though I was not convinced by his argument that ‘no compensation’ should be the general guiding principle. At least the ‘exceptional circumstances’ approach provides scope for debate over when compensation should be applied, to whom and in what form.

Finally, I also liked the emphasis given in this paper to supporting and strengthening the social capital (or capacity-building) of regional communities adversely affected by structural adjustment.

10.3 Some practical considerations

I never cease to be amazed by the naivety with which many economists address the practical aspects of redistribution and compensation. The contrast with the sophistication of the theoretical armoury used to analyse efficiency and growth is quite alarming. How many times have we heard ‘soft-hearted’ economists call for the adverse distributional effects of their policy recommendations to be offset by appropriate adjustments to the tax and transfer systems with no apparent regard for how (or whether) this can actually be achieved in practice?

Following the 1980s debate over compensation for the price effects of Option C, Peter Whiteford and I produced a report for the Australian Tax Research Foundation which analysed the adequacy of the compensation package proposed in the 1985 Draft White Paper on tax reform (Whiteford and Saunders 1990). We argued that while it was relatively simple to compensate the great majority of those adversely affected by the introduction of a GST, there are gaps in the coverage of tax and social security systems that create difficulties for any compensation package. We concluded that it was not possible to guarantee that nobody would be made worse off (within reasonable compensation cost limits) — even though politicians continue to claim that complete compensation can be achieved at reasonable cost (a point I will return to later).

This remains true today, despite the greater diversity of social security instruments resulting from another decade or so of targeting policies. Malcolm Gray notes the difficulties of achieving complete compensation coverage because some individuals pay little tax and receive few social security benefits. He argues that new measures may be required to protect those who fall through the existing gaps, but that 'any new measures be introduced within the broad framework and philosophy of the existing system and draw on experience of operating that system' (p. 110).

This sounds fine in theory, but in practice extending compensation to those not currently protected almost inevitably involves radical departures from existing policy and practice. The self-employed are the classic example of a group that falls into this category, but there are others such as self-funded retirees, recent migrants who do not satisfy the residence requirements for the pension and the young unemployed whose benefits are now income tested on parental income.

One group that creates problems for compensation are those affected by the income test who receive a part-rate benefit. Figures just released by the Department of Family and Community Services (FaCS) indicate, for example, that in June 1998, just over 10 per cent of all Newstart Allowance recipients earn an income above the benefit free area of \$60 a fortnight (FaCS 1999). It is not possible under current arrangements to provide the same degree of compensation to both full-rate and part-rate beneficiaries. Whether this is seen to be a problem depends partly upon judgements about equity, but also on other factors, in particular on the fact that changing the differential between full-rate and part-rate disposable incomes will affect the incentive of beneficiaries to seek part-time or low paid full-time work.

These are only a few examples of the kinds of practical problems that arise when considering the 'nuts and bolts' of compensation. However, they are not of marginal significance, but are central to the credibility and integrity of the whole compensation exercise. If the public is to be convinced of the need for change, they must be persuaded that the distributional offsets are fair, adequate and practical. Failure to achieve this can only lead to a cumulative build-up of resistance to the entire structural reform process.

This raises the issue of trust and the ability of politicians to deliver on their compensation promises. The GST experience does not provide much comfort here. At one stage, Fred Argy refers to the need for 'social smoothing' to apply over a reasonable period of time, which he interprets to be over five to eight years. The Australian political system makes it impossible for anyone to deliver on such a promise, and the public are right to be sceptical about promises that extend much beyond the next two years, at most.

Public opinion data reported by Richard Eckersley in his introduction to *Measuring Progress — Is Life Getting Better?*, indicate that the percentage of the population who rate politicians high in terms of their standards of ethics and honesty halved in the 20 years to 1995 and is now at about the same level as it was for workers in advertising in the mid-1970s (Eckersley 1998, table 2). Without trust in the political process, broadly defined, the possibility that acceptance of structural reforms can be obtained by promises to offset distributional changes (*ex ante* or *ex post*) seems remote.

Fred Argy presents a case for compensation measures to be targeted, by which he means restricted to groups made worse off by the change. He argues that universal subsidies are both *redistributively inefficient* and fiscally unsustainable. This proposition is ‘Holy Grail’ among Australian policy-makers, even though targeting lies at the root of most of our current poverty trap problems. In any case, as pointed out by Liz Savage, a universal payment may be more *behaviourally efficient* because the government can impose the highest marginal tax rates where substitution effects are lowest. Finally, there is a literature which suggests that public support is greater for universal than for targeted benefits, which suggests that the claim that the latter are more fiscally sustainable may itself be open to question. I am not aware of any evidence that targeting in Australia has increased public support for our social security system, and it is not self-evident that targeting is an optimal strategy, even on its own terms.

Two final comments in conclusion. The first concerns the need for *better data* to support distributional analyses of reforms. The limitations of the HES data for analysing how tax switch reforms affect living standards and inequality are readily apparent. In 1995, the ABS released a report outlining a provisional framework for the collection and reporting of data on household income, consumption, saving and wealth (ABS 1995), but little has yet been done to implement it. We also need far better longitudinal data if we are able to provide better estimates of how policy changes affect individuals over time and how enduring those changes are.

Providing *better* social data would be a start, but we also need *more* data; we need both if distributional issues are to be given more prominence. I have often speculated on how the world might change if we had the data to produce inequality and poverty statistics as frequently and with as much fanfare as we now devote to the balance of payments and other leading economic indicators.

My last comment relates to the view, expressed in several of the papers, that there is much to be gained from introducing a *package* of reforms and doing so through a *phased* approach to implementation. The argument appeared to be that both would reduce opposition to reforms and lower the adjustment costs, the former by

spreading the costs (and benefits) more widely across the population, and the latter by spreading them more evenly over time.

I did not find these arguments particularly convincing. Broad-banding can be interpreted as an attempt to dilute any opposition by creating confusion, while the success of reform phasing depends on a degree of trust in politicians that I have argued is lacking. Both strategies seem to me to be avoiding the central issue of the need for structural reforms to be equitable as well as efficient, and for this to be clearly and convincingly demonstrated. Until we can achieve this, structural reforms are always likely to meet considerable community resistance.

References

- ABS (Australian Bureau of Statistics) 1995, *A Provisional Framework for Household Income, Consumption, Saving and Wealth*, Cat. no. 6549.0, ABS, Canberra.
- Bradbury, B. 1994, 'Changing the income test for the unemployed: the discussion paper proposals', *SPRC Newsletter*, Social Policy Research Centre, University of New South Wales.
- Castles, F.G. 1985, *The Working Class and Welfare: Reflections on the Political Development of the Welfare State in Australia and New Zealand, 1890–1980*, Allen & Unwin, Sydney.
- Eckersley, R. 1998, 'Perspectives on progress: economic growth, quality of life and ecological sustainability', in Eckersley, R. (ed.) *Measuring Progress — Is Life getting Better?*, CSIRO, Melbourne, pp. 3–34.
- FaCS (Department of Family and Community Services) 1999, 'Social security statistics' in *Social Security Journal*, 1998/2.
- Whiteford, P. and Saunders, P. 1990, *Indirect Tax Reform and Low Income Groups: An Assessment of Methods of Compensation*, Research Study No. 10, Australian Tax Research Foundation, Sydney.



11 Issues in adjustment assistance

Andrew Stoeckel

11.1 Structural adjustment is a much worked over term

In 1977, the Industries Assistance Commission prepared three papers on this subject:

- *Structural Change and Economic Independence;*
- *Structural Change in Australia; and*
- *Some issues in Structural Adjustment.*

One of those papers opens with the line: ‘Change is one of the constant elements in the environment’.

I gather that there was a lot of debate in the Commission about this sentence. Now, twenty-two years later, it might be observed that talking about change is one of the constant elements in the environment. I note that none of the five papers presented here today refer to these three papers. That’s a pity as they are really very good.

Amongst other things the papers all emphasise that Australia as a relatively small open economy has little option but to take the world as it is. The Burma option would have been silly then and even sillier now.

It is a pity more reference is not made to the historical experience on compensation. The Commission has a rich experience in these matters. One example is the 1986 Textiles, Clothing and Footwear Advisory Committee report when, naturally enough, structural adjustment was an option. David McBride, a former union official and Commissioner, was adamant, based on his experience with the structural assistance applying with the 1972 twenty-five per cent tariff cut, that, in practice, adjustment assistance was unfair and wasteful. That some people who adjusted early got nothing and people in identical situations but, for some reason or other, had waited and cleaned up. That the net result had nothing to do with fairness, lead to bitterness about the process and did nothing to promote efficiency. Whether or not McBride was right is a moot point — but we should look at these episodes for the experience they teach us.

People, firms, governments and whatever produce and consume according to an infinite number of things including policies and institutions they operate in. It's appropriate and useful to argue about these policies and institutions — as Elizabeth Savage does when she critiques a GST or Cliff Walsh does when he makes the case for recalibrating how different levels of government might interact. But we don't need to invoke the language of structural adjustment to have these debates.

Governments (and voters) continuously face choices; between changes to a better (reform) policy, staying with the existing policy or moving to a worse policy. No change is as much a decision with consequences for structural change as is policy reform or policy debacles. As Wolfgang Kasper asks, why shouldn't compensation be as much an issue when governments opt for no action?

If, in 1977, Elizabeth Savage had told people in Sri Lanka (Cuthbertson and Athukorala 1991) that adjustment costs can be prolonged and severe and should be an essential part of the welfare calculation of policy change, they would have said the cost of no policy change and running a closed, state-dominated economy can be prolonged and severe and that they didn't have the time for any welfare calculations:

- the same is true of the people in Vietnam in 1989 (CIE 1998),
- or the people in New Zealand in 1986 (Stoeckel 1991).

These big episodes illustrate another point. If we want to give compensation or adjustment assistance, we are compensating for the costs for adjustment. We should give the most compensation/adjustment assistance when the costs are greatest. The costs are greatest when we have the big policy changes like in New Zealand in 1996. But in those circumstances no one worries about adjustment costs, so is that really what matters?

11.2 Kasper wants to let it happen, Argy and Savage want to make it happen

According to Savage, for each policy option, government should use a model of individual behaviour to estimate individual welfare gains and aggregate social gain.

Gray wants to build confidence in methodologies and techniques used to assess reforms. I would have thought a good case could be made for building scepticism about such models. And of course, so do Kasper and Walsh. Cliff Walsh refers to organised, vocal losers and silent winners. And of course the scope for these people to unduly influence policies which rely on detailed modelling, by getting their own modellers in, is immense. A good example is the recent motor car tariff debate. The

real debate should have been: why is the value added by cars twice as important as the value added in other industries?

Argy wants a government to define social goals precisely — Kasper wants them to evolve through civilised institutions. I must say that I think it is pie in the sky to expect governments to define social goals precisely and I'm not sure that I would want one to.

Savage cites a nice quote by Laffont (1989): '... very powerful economic instruments ... that often surpass the informational capabilities'. But she does not let that slow her down in wanting to understand the impact on every little thing, in advocating quite detailed understanding of policy effects.

As Wolfgang Kasper might say, conventional measures and definitions gloss over the world as it is and misrepresent the world it might become. So he thinks well informed targeted adjustment assistance is impractical at best and argues that the best governments can do is to reliably set broad parameters. I agree with this and people need to be clear on this point. Fred Argy, Elizabeth Savage and Malcolm Gray are saying you can measure welfare effects. Wolfgang Kasper is not just saying that you can't — he is driving a 'dagger through the heart' of their arguments. He is saying it is impossible and attempting to do so sends society backwards.

11.3 The public has had its fill of bad policy not reform

Its strange how we accept the view that the public has grown tired of microeconomic reform. According to Gray, there is growing resistance from some parts of the community to the dominant 'efficiency-first' paradigm. Gray refers to the growing public resistance to reform. And even Walsh refers to reform fatigue. Fred Argy refers to surveys that say Australians want an equal society — whatever that might mean. Argy is completely concerned about differences in income. Does he think that a low income person offered a policy which would increase his income by 20 per cent and the income of a rich person by 50 per cent would say, 'stuff that, let's stay where we are!'?

Great care needs to be exercised when interpreting observations about the distribution of income for policy significance. A couple of years ago, Angus Deaton (1997) gave a nice paper to the EMABA conference in Cairns. I do not have the reference, but it went something like this. He started out with a society of identical twenty-one year olds — all with the same endowment, talent, job and wage. This 'society' was then allowed to age with one difference: half the group saved, the other half 'partied on'. The distribution of income widened steadily over time. But

there is no cause for policy intervention at all. To what extent is today's income distribution reflecting different savings behaviour or some other choice variable?

Elizabeth Savage notes that 'Advocates of microeconomic reform often make claims of enhanced efficiency without any empirical support'. It might also be noted that advocates of the status quo — economic non-reform — often make claims for its maintenance without any empirical support. Indeed that's one of the most powerful features of National Competition Policy which places the onus on people advocating restrictions on competition to justify those restrictions in the public interest. Victoria of all the states has the public appearance of taking so called hard options; yet that government is topping the polls. Should we compensate people for living in Joan Kirner's Victoria and not Jeff Kennett's?

A few years ago the *Economist* ran a piece called, 'Soft systems versus crunchy systems' (Colchester 1996). The thrust of it was that policies that sought to paper over problems and delay or confuse responses, only resulted in delays and large pain when it happened. Whereas crunchy systems which faced economic agents with the truth of the matter straight away were more comfortable in the long run.

11.4 Sequencing, planning, adjustment costs — the international experience

Some of the international lessons from policy reform are instructive. The most comprehensive review remains that by the World Bank in looking at the experience of adjusting, mainly to trade liberalisation. The seven volumes were produced in 1990 and, although a little dated, so is the debate over structural adjustment. While the focus was on trade liberalisation, other policy reforms usually accompanied these reforms. The study looked at some thirty-six episodes across 19 countries. Some salient points were:

- *Sequencing*: no hard conclusion — it seems you are best to reform where the politics allow.
- *Phasing and strong reforms*: strong reforms associated with 'radicalism' (and presumably high adjustment costs) were more likely to endure and succeed than a hesitant or weak program. Many weak reforms experienced a back-flip with severe adjustment costs. A point is that policy failure can also lead to very high adjustment costs.

Related to the point about phasing is that of compromise. It does not always pay to compromise — the tax debate is an example of this. By the time half the products in a GST are exempt (health, good education, banking etc) and others are exempt over

time (housing for new home owners, tourism), the uneven system will resemble the system we now have. The same bad politics that gave us the WST is the same politics that will give us a bad GST.

11.5 Some other points

- It is not inevitable that everyone loses from microeconomic reform. Over the last decade, the sugar industry has been deregulated — to the early protests of sugar growers. The volume of sugar produced has since doubled. You would be hard pressed to find anyone who has lost out of this reform. Even the environment has gained as less fertiliser per hectare is used!
- Kasper is right to draw attention to the role of economic institutions as being critical for economic growth. The point is an important one. Douglas North was awarded the Nobel prize over six years ago for his work in this area. More could be made of the role of institutions (the rules of the game).
- Innovation is one of the driving forces for economic growth in society. Innovation is also determined by the institutions we have in place — the business laws governing bankruptcy, intellectual property rights, the culture of risk taking, etc. But adjustment assistance involves shielding people from change and, if institutionalised, itself can lead to a culture of risk aversion and even business laws that penalise risk taking rather than rewarding it. The end result could be much slower levels of innovation and therefore lower economic growth.
- Kasper is also right to note the impossibility of calculating the ‘proper’ compensation because the transient gains and losses cannot be known or measured. To this I would add: even if we could measure the compensation payments we would never sell the policy to the public. It is very hard to sell economic efficiency even where we can measure the gains. The sugar industry took ten years to work out that they would gain from deregulation (Borrell 1991).
- The costs of not adjusting can be enormous. The wool industry is a good contemporary example here (Stoeckel 1991). Thousands of farmers have had negative incomes for more than a decade. The social and human cost in the bush is enormous. The problem is a failed monopoly marketing strategy that has cost growers millions.
- Modelling: Dynamic models can and do measure adjustment costs. ‘Sticky’ wages, cost of moving capital, etc can be measured. The Commission should go down this route if it sticks to modelling to at least see how adjustment costs stack up against efficiency gains. Notwithstanding earlier comments about

models, some attempt at quantification of policy change is unavoidable if a scientific approach allowing repeatability and testing of ideas is to be adopted in looking at structural change.

- Regional assistance: Regional assistance is fraught with difficulties for the following reason. Regional adjustment must be geographically based. But the electoral system is also geographically based. Regional adjustment assistance will simply lead to pork barrelling.
- The government does not have to be involved in adjustment assistance. The diary industry has been through a massive amount of adjustment. A lot of that adjustment is managed through self-help programs run by the diary industry participants themselves. Finally, there are other ways to facilitate adjustment besides assistance or compensation programs. The objective of compensation of assistance programs is to lower the costs of adjustment. These costs arise because people may lose their job and have to find another one, for example, the extent of these costs will therefore depend on how skilled these workers are, how educated they are, and how flexible the economy is including the labour market. There are many things we can do to improve the flexibility of things like the labour market. Making these reforms is good for the economy and it is good for lowering adjustment costs and can remove much of the need for compensation for assistance programs in the first place.

References

- Borrell, B., Quirke, D. and Vincent, D. 1991, *Sugar Winning in a Corrupt World Market*, An independent report commissioned by CSR Limited, Centre for International Economics, Canberra.
- CIE (Centre for International Economics) 1998, *Vietnam's Trade Policies*, Prepared for The World Bank, Canberra.
- Colchester, N. 1996, 'Colchester's crunchiness', *Economist*, 5 October, p. 16.
- Cuthbertson, A. and Athukorala, P. 1991, *Liberalising Foreign Trade, Volume 5, The Experience of Indonesia, Pakistan, and Sri Lanka*, The World Bank, Basil Blackwell, Oxford.
- Deaton, A.S. and Paxson, C.H. 1997, 'The effects of economic and population growth on national saving and inequality', *Demography*, vol. 34, no. 1, pp. 97–114.

-
- 1998, 'Aging and inequality in income and health', *American Economic Review Papers and Proceedings*, vol. 88, no. 2, pp. 248–53.
- Department of Industry and Commerce 1986, *Textiles, Clothing and Footwear Advisory Committee report*, AGPS, Canberra.
- Industries Assistance Commission 1977a, *Some Issues in Structural Adjustment*, AGPS, Canberra.
- 1977b, *Structural Change and Economic Interdependence*, AGPS, Canberra.
- 1977c, *Structural Change in Australia*, AGPS, Canberra.
- Laffont, J.J. 1989, *Fundamentals of Public Economics*, MIT Press, Cambridge, USA.
- Stoeckel, A. 1991, *Wool into the 21st Century — Structuring the Industry for Success and Implications for the Stockpile*, An independent report commissioned by the Wool into the 21st Century Committee, Canberra.
- , Borrell, B. and Quirke, D. 1990, *Wool into the 21st Century - Implications for Marketing and Profitability*, An independent report commissioned by the Wool into the 21st Century Committee, Canberra.

A Brief for commissioned papers

What the project is about

Microeconomic reforms are pursued by governments primarily with the aim of raising productivity and community living standards. While the changes associated with these reforms deliver many benefits, they also give rise to adjustment pressures and associated costs. The last few years have witnessed growing public resistance to change and, in particular, to change created by microeconomic reform. This resistance stems from the fact that while reforms yield benefits for the community at large, they inevitably involve losses for some groups. Some groups in the community are questioning whether the pain associated with some reform is worth the gain. Related to this, some sections of the community have expressed concerns about how effectively governments have handled adjustment problems, particularly about how those adversely affected by reform have been treated.

Concerns and confusion about reform have the potential to threaten socially beneficial reforms. It is therefore important that policy decisions are made in the light of the best available information on the benefits and costs of reform, including the adjustment and distributional consequences, and related implementation issues.

Economic growth, the productivity performance of the Australian economy and structural adjustment issues are of central concern to the Productivity Commission. The Commission is required by its charter to have regard, amongst other things, to the Government's desire to facilitate adjustment within the economy by those people, industries and regions affected by its policy proposals. Responding to the challenge of improving Australia's productivity performance reinforces the importance of examining adjustment related issues.

To this end, in addition to focussing on adjustment issues in its public inquiries, the Commission is undertaking a broad stream of research directed at examining the adjustment and regional consequences of economic change. It is also examining adjustment issues in the context of the operation of Australia's labour market and the conduct of competition policy.

Against this backdrop, the Commission has identified three core policy questions which it will be examining as part of this research project.

-
1. Policy-induced changes and market-based changes give rise to adjustment costs and distributional effects. Should governments approach these two types of challenges differently or in a broadly similar way?
 2. How should adjustment and distributional issues be dealt with in the process of evaluating specific policy changes?
 3. What approaches work best to support the adjustment process associated with implementing policy changes?

The core policy questions are fairly broad and cover a wide range of issues. Set out below are a list of sub-questions that arise under each of the three core questions.

Potential issues to be covered under question 1 include:

- When is there a case for treating people affected by policy changes differently from those affected by market-based changes?
- To what extent does it depend on the type of policy changes and the adjustment challenges they present (eg broad framework changes such as tax and industrial relations reform compared with reforms having an industry focus such as trade liberalisation and product market deregulation)?

Question 2, which deals with the treatment of adjustment costs and distributional issues when evaluating policy changes, raises a number of sub-questions including:

- What types of adjustment costs need to be taken into account and how are these costs best assessed ex-ante?
- In what circumstances is it appropriate to systematically identify the main gainers and losers to provide an overview of the distributional effects of a policy change? In what ways can this be done?
- To what extent should governments trade off some of the efficiency benefits of reform against equity, regional development and other considerations? How are these competing considerations best assessed?

For example:

- : Is it appropriate to attach a higher weight to the interests of losers than the winners? If so, what would be the appropriate weights to apply? Should it depend on the circumstances of the winners and losers and, if so, what factors need to be taken into account and how is this best done?

-
- : Would it be preferable to adopt a conservative approach to reform whereby the potential efficiency gains would have to be demonstrably large relative to any adverse social or distributional consequences?
 - : Are there other approaches which could be used to handle these policy trade-offs?
 - Is it desirable to consider adjustment costs and distribution effects for each reform separately or look at a package of policy changes? Related to this, is there a case for allowing changes which have clear efficiency benefits to proceed and deal with any adjustment and equity concerns separately through generally available welfare measures?
 - Where should the onus of proof rest — with the advocates of reform or, as with national competition policy, the defenders of the status quo?

In the context of discussing what approaches work best to support the adjustment process (question 3), some of the sub-questions that arise include:

- Are gradual changes preferable to rapid changes in policy? Does it depend on the circumstances? If so, in what ways? What factors should influence the nature of any phasing arrangement (eg the time frame involved)?
- Does phasing in reform in accordance with a pre-announced schedule offer a better way of handling adjustment costs and the transitional phase than implementing the full change a few years after it is announced?
- Do phasing arrangements offer a better way of handling adjustment costs than the provision of financial assistance?
- Does a broadly based reform agenda provide a better framework for handling the adjustment process? Where broad based reform is not feasible, what implications would this have for pursuing a narrower range of policy changes?
- When is it appropriate to provide special compensation (over and above that available through the general social security system) to those who experience adjustment costs and losses as a consequence of a policy change?
- : If changes to government policy can be anticipated is there a case for compensation?

-
- : If the effect of a policy change is to remove policy privileges from some groups (such as tariff protection, monopoly status etc) should governments compensate the losers?
 - : Are there grounds for providing special compensation to buy-off resistance to reform?
 - If special compensation is considered appropriate, what form should it take, and on what terms?
 - What are the main potential problems associated with the provision of special compensation? Issues to be covered might include:
 - … disincentive effects (including incentives for lobbyists to seek compensation for other policy changes);
 - … identifying those who have been disadvantaged by a change in policy as distinct from other changes in the economy; and
 - … if compensation is considered appropriate for those who lose from a policy change, should those who gain from a policy change be taxed?
 - What decision rules or criteria could be applied to ensure that where special compensation is provided it is efficient and effective?

B Workshop program

8.30 - 9.00 **Registration**
9.00 - 9.15 **Welcome and opening address**
Gary Banks

Session 1: Evaluating policy changes — the economic and social dimensions
--

9.15 - 10.30 **A selection of views**
Speakers: Mr Fred Argy, Mr Malcolm Gray, Professor
 Wolfgang Kasper, Elizabeth Savage and
 Professor Cliff Walsh
10.30 Morning tea
11.00 - 12.30 **General discussion**
Discussants: Professor Peter Forsyth
 Professor Glenn Withers
Open discussion
12.30 - 1.45 Lunch

Session 2: Delivering effective adjustment assistance
--

1.45 - 3.00 **A selection of views**
Speakers: Professor Cliff Walsh, Elizabeth Savage,
 Professor Wolfgang Kasper, Mr Malcolm Gray
 and Mr Fred Argy
3.00 Afternoon tea
3.30 - 5.00 **General discussion**
Discussants: Professor Peter Saunders
 Dr Andrew Stoeckel
Open discussion
5.00 - 5.10 **Concluding comments**
Gary Banks



C List of participants

Mr Fred Argy	Australian National University
Mr Gary Banks	Productivity Commission
Mr Sitesh Bhojani	Australian Competition and Consumer Commission
Mr Graham Blinman	Productivity Commission
Associate Professor Jeff Borland	University of Melbourne
Mr David Borthwick	Department of Health and Aged Care
Dr Neil Byron	Productivity Commission
Mr Colin Clark	Productivity Commission
Mr John Cosgrove	Productivity Commission
Professor Ron Duncan	Australian National University
Professor Peter Forsyth	Monash University
Mr Timothy Geer	Productivity Commission
Mr Ian Gibbs	Productivity Commission
Mr Norm Gingell	Productivity Commission
Mr Malcolm Gray	Analytic Outcomes Pty Ltd
Mr Nicholas Gruen	Business Council of Australia
Dr Don Gunasekera	Productivity Commission
Mr Alan Johnston	Productivity Commission
Mr Brian Jones	Department of the Prime Minister and Cabinet
Professor Wolfgang Kasper	University of New South Wales
Dr Michael Keating	Australian National University
Mr Robert Kerr	Productivity Commission
Ms Amelia Lindsay	Productivity Commission
Mr Mark Lennon	Labour Council of New South Wales
Ms Rosalie McLachlan	Productivity Commission
Mr Alan Mitchell*	Australian Financial Review

Mr Ian Monday	Productivity Commission
Mr Des Moore	Institute for Private Enterprise
Ms Lyn Morgain*	ACT Council of Social Service
Mr Chris Murphy	Econtech
Dr Mike Nahan	Institute of Public Affairs
Mr Tom Nankivell	Productivity Commission
Mr Michael Paddon*	Public Sector Research Centre, University of New South Wales
Mr Dean Parham	Productivity Commission
Mr Garth Pitkethly	Productivity Commission
Mr Herb Plunkett	Productivity Commission
Mr Gary Potts	Department of the Treasury
Ms Paulette Quang	Department of Agriculture, Fisheries and Forestry
Mr Graeme Samuel	National Competition Council
Professor Peter Saunders	Social Policy Research Centre, University of New South Wales
Elizabeth Savage	University of Sydney
Mr Don Siemon*	Brotherhood of St Laurence
Professor Judith Sloan	Productivity Commission
Mr John Spasojevic*	Department of Industry, Science and Resources
Dr Andrew Stoeckel	Centre for International Economics
Professor Cliff Walsh	SA Centre for Economic Studies
Dr Lynne Williams	Productivity Commission
Professor Glenn Withers	Graduate Program in Public Policy, Australian National University
Mr Alan Wood	The Australian
Mr Michael Woods	Productivity Commission
Mr John Zeitsch*	Tasman Asia Pacific

* Accepted the Productivity Commission's invitation to attend the workshop but were unable to participate on the day.

D Speaker and discussant profiles

Fred Argy

Visiting Fellow, Public Policy Program, Australian National University and occasional consultant.

Fred is a former Director of the Office of the Economic Planning Advisory Council, 1986–91. Other positions include Commissioner at the Commonwealth Grants Commission, Deputy Secretary at the Department for Employment, First Assistant Secretary at the Commonwealth Treasury and Australian Ambassador to the OECD. Fred was the Secretary to the Campbell Inquiry into the Australian Financial System (1979–81), has been a Research Adviser to the Committee for Economic Development of Australia (CEDA) and past President of the Economics Society of Australia.

Fred has written many articles. Two well read books include: *Australia at the Crossroads: radical free market or a progressive liberalism?* (1998) and *A Vision for Australia* (CEDA, 1993).

Malcolm Gray

Director, Analytic Outcomes Pty Ltd.

Before becoming a consultant in 1997, Malcolm worked as the Group Economist for CRA Ltd. He has held senior positions in the federal bureaucracy including Deputy Secretary of the Department of Industrial Relations, Deputy Secretary (acting) in the Department of the Prime Minister and Cabinet and Senior Economic Adviser to the Prime Minister from 1990 to 1991. Malcolm has also been a Senior Research Fellow and Lecturer at the Australian National University and a board member of the Construction Industry Development Agency. Malcolm has publications covering the demand for financial assets, expectations theory and macro-economic modelling.

Wolfgang Kasper

Professor of Economics, University College, Australian Defence Force Academy.

Prior to taking up his present position in 1977, Wolfgang held senior positions at the Australian National University and Reserve Bank of Australia. Wolfgang has had extensive experience overseas including positions with the German Council of

Economic Advisers, the Kiel Institute of World Economics and adviser to the Malaysian Treasury. Wolfgang serves on the Board of the International Schumpeter Society, and is a member of advisory committees at the Centre for Independent Studies and the Centre for the New Europe in Brussels.

Wolfgang has published extensively on topics ranging from economic liberalism, federalism, international trade and finance, innovation and the economies of East Asia. Some key publications include: *Institutional Economics — Social Order and Public Policy* (1998); *Free to Work — The Liberalisation of New Zealand Labour Markets* (1996); *Our Industrial Future — by Council or Competition?* (1985); and *Australia at the Crossroads: Our Choices to the Year 2000* (1980).

Elizabeth Savage

Senior Lecturer, Department of Economics, University of Sydney

Elizabeth has been with the University of Sydney since 1979. She has held a variety of visiting appointments with Australian and overseas universities. She was an economic adviser to ACOSS at the 1985 National Tax Summit and has worked in the Department of the Prime Minister and Cabinet. Elizabeth has worked as a consultant for clients ranging from the Office of EPAC, the Public Sector Management Institute, the NSW Social Policy Directorate, to the World Bank.

Elizabeth's research interests cover tax and social security (with particular emphasis on welfare measurement and analysis of inequality), the pricing of public utility outputs and various labour market issues. Some of Elizabeth's many publications include: 'Trends in economic policy for the aged: an evaluation of user pays, cost recovery and means testing' in *Who Pays? the impact of user pays and economic policy on older people*, NSW Committee on Ageing (1998); 'An evaluation of income splitting with variable female labour supply', *Economic Record* (1996); 'Environmental Economic Policy in a Second Best Environment', *Economic Papers* (1995); 'The economics of User Pays: a second best perspective', in *User Payers: Emerging Gains and Losses for the Public Sector*, J Coulter (ed) Public Sector Research Centre, University of NSW (1994); and 'Modelling Australian indirect tax reforms: a welfare consistent approach' in J.G. Head (ed) *Australian Tax Reform in Retrospect and Prospect* (1989).

Cliff Walsh

Professor and Executive Director, South Australian Centre for Economic Studies.

Prior to joining the Centre in 1992, Cliff was a Professor and Director at the Federal Research Centre, Research School of Social Sciences at the Australian National University, the Professor of Economics at the University of Adelaide, and in the early-1980s, the Principal Economic Adviser to the Prime Minister. Cliff has been

involved in several government committees and inquiries, including the Industry Commission's inquiry into *Impediments to Regional Industry Adjustment* (1993), the Committee for the Review of State Taxes and Charges (Tasmania, 1993), the Committee to Review Australia's Overseas Aid Program (1997) and the Advisory Panel for preparing the White Paper *In the National Interest: Australia's Foreign and Trade Policy* (1997). He is currently a member of the Foreign Affairs Council, the SA Government's Local Government Boundary Reform Board, the Deputy Chair of the Taskforce on Regional Development in SA and is the Adviser to the SA Premier on Commonwealth-State issues.

Cliff's major research, consultancy and publication fields include: public sector economics; intergovernmental fiscal, political and administrative relations; international trade and aid; government finances and taxation; and regional economic policy. Some of his many presentations and publications include: *What is Good Social Policy?* (paper presented to a NARU workshop, 1998); *Hilmer Competition Policy: How its Implementation will affect South Australia* (1995); *Intergovernmental Relations and Public Policy* (1991); *Issues in State Taxation* (ed, 1990); and co-authored with John Freebairn and Michael Porter three books — *Savings and Productivity: Incentives for the 1990s* (1989); *Spending and Taxing II: Taking Stock* (1988) and *Spending and Taxing: Australian Reform Options* (1987).

Peter Forsyth

Professor of Economics and Head, Department of Economics, Monash University

Prior to joining Monash University in 1997, Peter was Professor of Economics at University of New England and lectured in Economics at the Australian National University and the University of New South Wales. He was a member of the National Grid Management Council Consultative Working Group (1990–94). Peter is well known for his work in applied microeconomics, notably in the areas of the economics of transport and tourism and the economic effects of privatisation and regulation. He has many publications in these areas and edited the widely read book *Microeconomic Reform in Australia* (1992).

Peter Saunders

Director, Social Policy Research Centre at the University of New South Wales.

Peter has been with the Centre since 1987. Prior to joining the Centre, Peter taught economics in universities in Britain and at the University of Sydney. He has also worked for the OECD and been a consultant for the IMF, the New Zealand Royal Commission on Social Policy and the Economic and Social Commission for Asia and the Pacific. His main research interests include inequality and income distribution, poverty, social security and the economics of the welfare state. His book, *Welfare and*

Inequality, National and International Perspectives on the Australian Welfare State, was published in 1994. Among his recent research interests are a study of the development of indicative budget standards for Australia, further analysis of the meaning and measurement of poverty, an investigation into the links between poverty, income inequality and health in Australia and the development of social security protection in the countries of East and Southeast Asia. He was elected a Fellow of the Academy of the Social Sciences in Australia in 1995.

Andrew Stoeckel

Executive Director, Centre for International Economics (CIE).

Andrew has headed the CIE — one of Australia's leading private economic research consultancies — for the last ten years. He was formerly the Director of the Bureau of Agricultural Economics. Andrew is a specialist in policy analysis and the international economy. He has initiated and directed programs of research which have included studies of European agricultural policies and international trade. Andrew provides regular briefings for major Australian clients on the short and longer term world outlook and implications for commodity prices. Major industries that he has undertaken extensive policy analysis on include tourism, health, water, food processing, beef and wool. He has led economic missions to overseas countries as well as briefing foreign governments on trade policy.

Glenn Withers

Professor of Public Policy, Asia-Pacific School of Economics and Management, Australian National University.

Prior to taking up his present position, Glenn was Commissioner of the Economic Planning Advisory Commission, 1991 to 1996. He has held a number of academic positions and has consulted widely for government and the private sector. Glenn has been on various public committees and inquiries including being the Chair of the *Private Provision of Infrastructure* inquiry (1994–95) and inquiries on immigration and population. He has been the Chair of the National Population Council and the Migrant Skills and Qualifications Board. Glenn is a Fellow of the Academy of Social Sciences in Australia.

Glenn has published on a number of topics including immigration, labour markets, competition policy, industry policy and the performing arts. Some of his recent works include: *Policy for Australia's Industrial Future* (with Margaret Mead, CEDA) and *Immigration and Australia: Myths and Realities* (with Castles, Foster and Iredale).