Charities Reform in Australia

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Australia has a large investment in altruism. There are over 50,000 charities in Australia (Australian Taxation Office, 2001), supported by about one-third of individual taxpayers, worth nearly $3 billion (Centre of Philanthropy and Nonprofit Studies, 2004:1) every year. Australian donors do not know if their investment in altruism is wise. They do not have the information to judge whether their donations are put to best use. Measures of performance are available for investors in the corporate sector, and for voters in the government sector. They should be available for donors who support the charity sector.

As an acknowledgement of the growth and importance of charities, the sector has sought to expand the definition of charity in terms of both purposes and the means by which they are achieved. It has also sought regulatory reform, including the establishment of a Charities Commission. To date, the Australian government has accepted an expanded range of charitable purposes, but has not clarified what constitutes acceptable charitable activities. It does not appear willing to engage in regulatory reform, including the establishment of a regulator for the sector.

A key principle of charity reform is whether charities inform their donors sufficiently well of their activities. Charities have a case to answer that they do not keep donors well informed, an especially important issue when charities are claiming a larger role in the distribution of government resources and in advocating public policy. The paper discusses a proposed model for charity disclosure aimed at achieving an informed donor market. The model is designed to provide a powerful tool for scrutiny as well as a guide to acceptable purposes and activities. The paper argues that the government should assist the sector to achieve the standard of disclosure suggested, and establish a dedicated regulator.

What is a Charity?

Charities operate for a wide array of purposes and in any number of ways. The Australian Taxation Office uses the generic term ‘not-for-profit’ (NFP) to cover the range of organisations that receive tax assistance. The NFP generic consists of charities, health promotion charities, and public benevolent institutions, and encompasses entities such as welfare providers, hospitals, universities, and a myriad of others. These variously have access to tax concessions in income tax, fringe benefits tax, Deductible Gift Recipient Status, Goods and Services Tax, refunds of Imputation Credits, and a range of state government concessions such as stamp duty, payroll tax, land tax, and debits tax. For the purposes of the discussion the term charity will be applied to any NFP that benefits from public support through the taxation system because the term charity carries the most

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powerful and familiar connotation of ‘doing good’. Each of the entities has achieved their ‘charitable’ status more by the intention to do good works, than by any proof that they in fact do so. Moreover, the range and nature of objectives and activities undertaken in the name of charity has expanded enormously in recent years. For example, The Australian Conservation Foundation, Friends of the Earth, Greenpeace, and The Wilderness Society are ‘environmental charities’. This may surprise those who understand charities to be predominantly working to help the sick and the poor.

Moreover, some charities are very active in government. For instance, the Queensland Conservation Council boasts 60 representatives sitting as environmental consultants on committees throughout the state. Even those that help the sick and the poor want to do it differently, they want to overcome inequality. Russell Rollason (2003) of Anglicare asked: ‘Is the role of charities and churches simply to apply band aids to the victims of our competitive society or should charities actively contribute to a fairer more just Australia?’ Indeed, the way charities go about their business can raise doubts as to the purpose of their charitable activity. A very astute question by Senator Brandis, the Chair of the Senate Economics Legislation Committee on this issue, ‘is the purpose [of the charity] attenuated by the mode of advocacy?’ elicited the following response by the Commissioner of Taxation: ‘It may well be’ (Senate Hansard June 3, 2004).

There is an assumption in the public support of charities that a donor understands the purpose of the charity. When the charity’s methods are direct — giving aid to the poor, planting trees, and writing letters to foreign governments on behalf of political prisoners — the task of informing the donor is not great, because the purpose is unambiguous. As the methods and definition of charities widen however, the assumption of donor knowledge may not hold. Consider these examples:

- A welfare charity no longer solely gives aid directly to the poor, but uses its resources to argue that the tax system achieve equality. It is debatable whether lobbying government in the pursuit of an egalitarian ideology — through more generous unemployment benefits or a more progressive tax system — constitutes charity for the poor.
- An environmental charity that lobbies government to tax hydrocarbons may not be performing a public benefit. It is just as likely to be pursuing an environmental ideology based on assumptions of resource depletion.
- It is debatable that a human rights charity that lobbies for the International Criminal Court is pursuing little more than an anti nation-state ideology.

In these ways, and many others, lobbying by charities is meant to divert public resources to their favourite cause. Charity work is no longer unambiguously good, or for the public benefit. It may be altruistic, but increasingly it is embedded in a political framework that seeks to use public power for system change. These methods are unambiguously political in nature. Arguably, it is at odds with the donating public’s expectations of the charities.
There is another class of behaviour that may also be at odds with public expectations. Where charities compete with private providers to deliver government services, for example, domestic welfare and employment services or foreign aid services there may be an unfair advantage awarded the charity. The government, or the donating public, may be comfortable with such an advantage being granted, but it would be more equitable if the advantage was known and conveyed to the donor, which at present appears not to be the case.

These debates would not matter so much if charity status did not carry tax-assisted privileges and if donors were well aware of the work of charities. As charities are publicly assisted, and as it is unlikely that donors are fully aware of their activities, there is a need to scrutinise the activities of charities. This already takes place in two respects. Charities are subject to state laws governing their fundraising, and they are registered under the Taxation Act and therefore have to prove their purpose, for example, to be publicly beneficial. The proof required to gain a tax-advantaged status is minimal and almost none of the relevant legislation aims to keep the donor well informed. For the purposes of the donor making an informed decision, the regulation is wholly uninformative.

The Donor as Regulator

There are two concepts of charities’ behaviour that may be useful in understanding the need to inform donors. First, charities raise their funds by acting as agents in pursuit of the donors’ wishes. Second, charity advocates seek to raise funds from donors to further the cause most dear to the heart of the advocate. Donors need sufficient information to decide if the charity is an agent or an advocate or, if both, in what proportion. The donor has the power to withdraw support if dissatisfied with the charity’s performance, but a continuing interest only arises with continuing donations. It is a weaker power than that of shareholders who can sell their part in an enterprise if dissatisfied with its performance. Such power as the donor has is best used when based on good information (for example, evidence of the fulfilment of the charity’s mission). While an essential element of disclosure is the charity’s mission statement, so also is evidence of the mission’s completion. Did the charity do what it promised? Did it fulfil its mission in the most efficient way? Measures of efficiency and effectiveness would aid the donor in deciding how, or indeed whether, to spend their money.

From the donors’ point of view, there is a gaping hole in the scrutiny of charities. The present scrutiny does not provide an answer to the question: are charities any good at what they do? In the stockmarket, there are those who analyse corporations and advise investors. There is a market in information. In the donor market, there is no incentive to analyse the performance of charities because the ‘investment’ by the donor is usually insufficient to warrant the cost of advice. Consequently, there is no money to be made in analysing charities. In the case of large philanthropic donors, such as foundations, who may be willing to pay for information, the notion of a ‘return’ on the donation has either been eschewed, or subsumed by the emotional response to the cause. They do not appear to want
to know the answers to the crucial questions of performance, or if they do, they
gather the material for their own use, and are under no obligation to inform other
donors. Such attitudes also prevail with respect to accountability requirements for
foundations (Leat, 2004). Furthermore, these donors are in much the same
position with respect to charities as are institutional investors to public companies.
Many philanthropic donors have representatives on the boards of the beneficiaries
of their gifts, so they may be reluctant to enforce a set of disclosures that would
allow other donors to make a judgement about the performance of their charities.
There are organisations that keep an eye on charity performance. For
example, Givewell gathers material on the fundraising costs of charities and other
relevant material. The difficulty is that it can only list information that is
available, most of which is incomplete or not comparable. An example of a
website where many charities’ activities can be viewed is Donations.com.au. The
service ‘streamlines the fundraising activities’ of the donor by depositing directly
into the bank account of the selected organisation. There are, however, no data
whichever to make a judgement about the efficacy of the organisation. The
decision to donate is based on the emotion of the cause. The donor’s trust in the
charity is assumed. The Australian service may be compared with one based in
the USA (Give.org) which for many years has established and scrutinised
standards of disclosure by charities. The Australian Consumers’ Association
(ACA) attempted a survey of charities in 2002, seeking to answer the question:
‘Which ones are worthy of your generosity?’ The ACA abandoned its attempt to
rate the worth of charities, concluding (ACA, 2002):

Unfortunately, charities don’t have to comply with any uniform standard
for presenting their financial reports. That means the way they break
down income and expenditure can vary, [and] it’s difficult to exactly
compare one charity against another.

An attempt to understand the extent to which a donor may use published
information on performance to decide to support a charity has been made by the
Charity Commission for England and Wales (2004a). Using a recent survey of
public attitudes in the UK, the results show that:

- the public considers the principles of transparency and accountability to be
  important;
- information about the areas of activity on which charities have spent their
  money was considered the most important; and
- sixty per cent of respondents said that the ability to compare important
  information between charities would affect their decision about which charity
to support.

Similarly, a survey of Canadian opinion conducted on behalf of the Muttart
Foundation (2004:5) has indicated that Canadians place a great deal of importance
on receiving information about charities and the work they do, and ‘almost all
respondents indicate that it was important that charities provided information on how they use donations, their fundraising costs and the impact of their work.’

In Australia, each state has its own laws governing public collections and fundraising. The terms and requirements of the various Acts vary quite significantly, as does the way they are interpreted. For example, in NSW and Victoria, the Acts relating to charities require them to disclose their fundraising income and expenditure. Givewell’s research, however, has shown that the rate of adherence to those requirements — though better in NSW — is quite variable in both states. Similarly, a study by the Institute of Chartered Accountants in Australia (ICAA) analysed the financial and annual reports of 22 major NFPs in matters such as the disclosure of fundraising costs. Using the NSW Charitable Fundraising Act 1991 as its measure, it found that only four of the reports included data to comply with the requirements of this Act. The ICAA report also found that only three of the 14 NFPs ‘who would have incurred a deficit without a government grant’, included in their financial report disclosure of this crucial information (ICAA, 2003a:25). Although meeting the requirements imposed by Federal and State legislation in general terms, the ICAA review found that the reports of most NFP organisations did not satisfy the needs of two of their key stakeholder groups, the donor and the funding provider (ICAA, 2003b).

More disconcerting is evidence of reluctance in the sector to disclose relevant facts about their activities. A recent survey of regulatory issues in the NFP sector found that, ‘a startling nine per cent of respondents thought that no information should be made available to the public, while only 39 per cent agreed with fully audited accounts being disclosed (as is currently required by the Corporations Act), and just over half thought summary financial information should be enough’ (Woodward and Marshall, 2004:2). The Australian Taxation Office (ATO, 2001:26) has argued that ‘if more information on concessionally taxed bodies was made publicly available … the public and organisations could more easily bring non-compliant behaviour to the ATO’s attention, or other relevant agency’. The issue is: what kind of information? In an increasingly politicised sector, keeping donors well informed may require the public disclosure by charities to donors of three things — the efficiency of the charity, the nature of the work undertaken in the name of the charity, and the achievements of the charity. Donors may have little voice in the charity, but, armed with good information, they would have the power of spending their donor dollar elsewhere.

**Modest Reform So Far**

A number of major studies of, and inquiries into, the charity sector in the last decade have recognized the important work of the sector, but also its variable legal form and difficult-to-define boundaries. An inquiry undertaken in 1995 by the Industry Commission (IC, 1995), _Charitable Organisations in Australia_, provided some very good data and sound recommendations as to how the sector may be better regulated. A second inquiry, the Charities Definition Inquiry (CDI, 2001) sought to define a charity better. Its recommendations are contained in _Report of_
the Inquiry into the Definition of Charities and Related Organisations. In submissions to the Charities Definition Inquiry, the sector sought to expand the definition of charity work (Australian Environment Organisations, 2001:1), and reap the benefits of an ‘independent’ regulator (Australian Council of Social Services, 2001:3). The Industry Commission recommendations have been largely ignored. Instead, a lesser raft of changes arising from the Charities Definition Inquiry has produced modest change.

The Australian government introduced the Charities Bill 2003 in an attempt to define charitable activities better. The Bill was withdrawn, however, after advice from the Board of Taxation in December 2003 that it ‘failed to achieve the level of clarity and certainty’ that was intended (Board of Taxation 2003). Having failed in its attempt to introduce a legislative definition of a ‘charity’, the Government decided to continue to rely on the common law meaning. The only change was to extend the definition ‘to include non-profit child care available to the public, self-help groups with open and non-discriminatory membership, and closed or contemplative religious orders ’ (Commonwealth Treasurer, 2004).

In addition, legislation was tabled in Parliament on 19 February 2004 requiring charities, public benevolent institutions and health promotion charities to be endorsed by the Tax Commissioner in order to access relevant taxation concessions. The amendments extended the endorsement processes currently undertaken by the ATO to all taxation concessions, to which charities, public benevolent institution and health promotion charities are entitled (ATO, 2004a). The changes updated the list of charities, but the same method of self-assessment — ‘It is your responsibility to advise the Tax Office if you are no longer entitled to endorsement’ — and hands-off regulation continue (ATO, 2004b:31). In other words, the entire focus of reform has been in taxation compliance, with little regard to informing the donor of the activities and performance of charities.

A Standard of Disclosure

The major parts of the reform agenda — the need for a sound basis in regulation and a much better set of indicators of performance — remain to be addressed. In these regards, the Industry Commission Report recommendations of 1995 (IC, 1995) provide a guide, as do two further substantial studies. The ICAA (2003) review of financial and annual reports of 20 major non-profits in Australia, which recommended a specific financial reporting framework and standard, and the University of Melbourne Centre for Corporate Law and Securities Regulation 2004 study (Woodward and Marshall, 2004), which recommended the need for uniform regulation and comparable standards of disclosure.

The Industry Commission (1995:xxiii) argued that donations to charities deducted from a donors’ income for tax assessment purposes,

can lever greater funds … from the public than are forgone in tax revenue. So it can be an efficient, though indirect, means for the Commonwealth government to fund [charities] … It also allows the
public to decide which organisations should receive support from the
government.

The missing ingredient was data that would enable donors to compare the
fundraising activities of charities over time and between organisations. The
Commission (p. xxxvii) recommended that financial information requirements
about fundraising should be met ‘through a sector-specific accounting standard
and form of incorporation’. It made the point that most States/Territories lacked
the systems necessary to collect the information and make it available to the public
in a useable form.

The Industry Commission (1995:205) identified the following problems with
the system:

• lack of consistent data collection processes;
• lack of public access to information; and
• lack of standardisation of financial reporting and other information.

The main issue is to define the type and amount of data that would satisfy the
donor and other relevant stakeholders. A 2004 survey of NFPs showed that
respondents claimed that reporting obligations were excessive. The study
concluded, however, that this was not a reason to reduce disclosure, but rather it
made the case to ensure appropriate disclosure. ‘[W]hat is required to be
disclosed and by whom’ (Woodward and Marshall, 2004:5) was to be more
accurately assessed, so that, for example, there would be greater disclosure on
some issues such as description of activities, directors’ remuneration, and related
title transactions. The study recommended that a minimum disclosure standard
for all NFP organisations, regardless of size, should include: a summary or
concise financial statement, based on a specific accounting standard; a description
of the activities, and how they meet the objects of the organisation; and disclosure
of directors’ remuneration.

For larger organisations, the study (p. 5) recommended that there should be
audited accounts and disclosure of the amount (and possibly sources) of public
funding. For small organisations (those with an annual income or total annual
expenditure of less than $100,000), ASIC, or a certain percentage of members of
the organisation, should have the power to require any organisation to be audited.
In addition, the reporting obligations under various Acts — including the
Corporations Act 2001 (Cth) and various State Fundraising and Collection Acts
— should be unified. Multiple filings should be avoided and low-cost, online
searching facilities should be available to maximise transparency. Further,
reporting obligations should constitute a ‘one-stop’ report that would aim to
satisfy the needs of various bodies (Woodward and Marshall, 2004:6).

One of the most sensitive elements of a disclosure regime is the fundraising
ratio. There are two essential issues. The first is that there is currently no
requirement under the Corporations Act to disclose marketing expenditure
compared with fundraising receipts and there is considerable inconsistency
between the Fundraising and Collection Acts of the States and Territories. Attempts to compare fundraising costs are inherently difficult as they may vary, for example, with the popularity of the cause. Revenue from fundraising, gifts, memberships, dues and association fees, and the sale of goods and services needs to be disclosed. This is in addition to disclosure of moneys spent on administration, advertising, promotion, and the like. It is difficult to determine the costs that should be allocated to fundraising, and there are problems such as the apportionment of overheads and campaign costs over the period of fundraising benefit, but standardised accounting methods are achievable. Woodward and Marshall (2004:8) recommended further consideration of the matter by the Australian Accounting Standards Board.

A second element of the fundraising ratio is whether there should be legislative controls on the costs of fundraising. The US and Canadian disclosure regimes for charities specify upper limits on cost of fundraising and on expenditure on advocacy. Interestingly, a recent survey (Muttart, 2004:6) of Canadian attitudes to the latter restriction indicates strong support for charities speaking out on public issues, and ‘that existing laws should be relaxed so that charities can speak out more freely on their cause.’ The Fundraising Appeals Act in Victoria for example, ‘does not specify a percentage of funds raised … that must always be distributed to the beneficiaries. The approach is based ‘on allowing retention of a reasonable proportion of the funds raised’ (Consumer Affairs, 2004:9).

The current review of the Act is considering whether the present system is effective in ensuring that ‘excessive amounts of proceeds are not retained for administrative costs or whether the Act should specify a percentage of funds that must be distributed to beneficiaries’ (Consumer Affairs, 2004:9). The difficulty with such ‘standards’ is not only that they are arbitrary, but also there are no objective criteria for determining the appropriate limit. Limits may also encourage organisations to underestimate their expenses. Legislation would restrict the ability of high cost organisations to conduct fundraising when there may be legitimate reasons for high fundraising costs for like charities. The Industry Commission considered that legislative controls on the ‘acceptable’ ratio of costs to fundraising were not desirable (IC, 1995:237). The best policy with respect to standards of performance in fundraising is to allow the donors to make an informed decision.

Subject to further work on definitions of fundraising costs, the ICAA has established a standard of financial reporting that should make an excellent template for any regulator. It recommends that a General Purpose Financial Report (GPFR) should be available in most circumstances (ICAA, 2003:18). The ICAA argued that the following accounting concepts should form the framework of financial reporting for NFPs. Foremost is that the characteristics of the stakeholders determine the information needs. For example, ‘the greater the spread of ownership/membership and the greater the extent of separation between management and the owners/members or others with an economic interest in the entity, the more likely it will be that there will exist users dependent on GPFR as a
basis for making and evaluation resource allocation decisions’. Further, ‘the greater the economic or political importance of an entity, the more likely it is that there will exist users dependent on GPFR’. Finally, ‘If … NFPs raise funds from the general public by way of appeal or membership and seek support by way of grants from governments and philanthropic organisations, the NFPs’ Financial Reports might be used to make decisions as to where donations or descriptions are directed or whether grants are made’. The ICAA (2003:7) strongly recommended NFPs develop their reports to enlighten the donor in two dimensions, both of which involve Key Performance Indicators (KPIs), namely Process KPIs — those which measure the effectiveness of activities such as fundraising and administration, and Impact KPIs — those which measure the effectiveness of the delivery aspects of the NFP (for example, the number of people assisted or treated, the proportion of people suffering from an affliction assisted by the organisation).

The ICAA also recommended that NFPs report on their three core business segments; generating funds, administering funds and spending funds. This reporting enables comparison of the performance of similar NFPs and meets the needs of donors and grantors. It does not suggest that all NFPs must comply in every respect, but the intention is clear, it wants NFPs to be able to make straightforward statements such as, ‘what we are trying to do’, ‘how we are going about it’, and ‘what we have achieved during the year’ (the complete pro-forma of questions for charities can be found at www.icaa.org.au). These statements combined with the use of various Australian Accounting Standards are likely to provide a sufficient standard for a well-informed donor market. The regulator, in conjunction with the sector, should stimulate further work on standards.

Regulator or Advocate: A Charities Commission or the ASIC?

Although the accountants can agree on the standard of reporting, the question of who is best to regulate may be more difficult to resolve. The Industry Commission (1995:207) considered several strategies for improving the accountability of charities to donors and the availability of information to the public, including: the establishment of a body responsible for supervision and monitoring charities; the incorporation of charities as public companies under the Corporations Law; and the provision of funds by the Australian Government for the development of an accounting standard specific to the sector.

The Commission argued that the Australian government could require those organisations that wish to raise tax-deductible donations to incorporate in the prescribed way. Linking tax deductibility and this form of incorporation would ensure that donors (and the community in general) would be able to access information about the finances and operations of the charities they support (IC, 1995:218). The state regulators would presumably bring their regulation for fundraising into line with the Commonwealth’s. The Woodward and Marshall study reinforced the Commission’s themes, recommending a single Commonwealth regulatory regime, with ASIC becoming the new regulator (at least until any new regulator is introduced), and the establishment of a specialist
unit within ASIC. It also argued that a new independent NFP advisory body should be established to meet this need. A range of support services could be provided at low or no cost — for example, auditing, financial and taxation advice, legal advice, training for Board members, and dispute resolution for stakeholders.

Speaking as Chair of the National Roundtable of Nonprofit Organisations (2004:7) Robert Fitzgerald argued that disclosure is a key to promoting a more efficient and sustainable environment for nonprofit organisations … There is a particular need for information to be disclosed in ways that answer the questions that those interested in nonprofit organisations are likely to have … The Government must be committed to the strong and effective enforcement and facilitation of nonprofit regulation and provide adequate resources to agencies tasked with such responsibilities.

The sector appears to support a uniform standard of regulation, and their advocacy for this is long held and to be applauded. The sector, or at least that part of the industry represented by the Nonprofit Roundtable, however, sees the issue in wider political terms. For example, it recalls the Charities Definition Inquiry recommendation for the creation of an ‘independent’ commission, such as the Charity Commission in the UK. The body would have responsibility for looking at the overall regulatory regime of charities throughout Australia, and take certain responsibilities from the Australian Taxation Office (Fitzgerald, 2003:8). The sector’s keenness to remove responsibility for charities from the ATO stems from its view that, ‘the gate-keeping role [of] the Australian Taxation Office … means that revenue concerns overshadow broader public interest concerns in defining charitable purposes’ (Australian Council of Social services, 2001:10).

The sector is concerned that the tax system is being used to control or inhibit the activities or voice of nonprofit organisations.

If governments don’t like particular organisations then they don’t have to fund them. If the community overall doesn’t like the advocacy of a particular organisation, it won’t support it — it won’t provide money, nor will it provide voluntary effort, and in the end the marketplace will have its effect. We must always guard against regulatory regimes and contracted requirements that seek to limit the ability of any organisation to have a go and have a say (Fitzgerald, 2003:12).

There is some support for Robert Fitzgerald’s concerns in a recent survey of NGOs’ attitudes to the Australian government. The report concluded that

There has been a serious deterioration in relations between the Federal Government and NGOs to the point where many believe they have been frozen out’ and fear they will have their funding withdrawn. The concerns of the NGO sector were heightened by the proposal by the
Treasurer to disqualify a charity that engages in advocacy that is other than ancillary or incidental. (Maddison, 2004:7)

The sector is well aware of the realpolitik of charity registration. A charity that may have been on the books for many years, but whose aims and methods (not to mention its competence) may presently be almost unrecognisable, has the advantage of incumbency. Governments are very reluctant to be seen to police charities, and to cause one to lose its charity status would be a bold move indeed. The sector knows this, and the few that have been removed from the list in recent years had all but ceased to exist anyway. The ‘marketplace will have its effect’ — but only if it is well informed. The sector seems to want a sympathetic regulator as a counterweight to government. It claims a ‘right to special treatment by the community through the tax system’ and a ‘right to speak out and to influence public policy’ (Fitzgerald, 2003:10). The right to special treatment, however, cannot be taken for granted. The price must be a disclosure regime that satisfies the donor. The assertion of the right to special treatment also assumes that there is no ongoing discussion of the legitimacy of charities’ purposes and practices. The fact is that the right to speak out and to influence public policy is nowhere under threat, because this ‘right’ is not granted by the government. It is a long-established practice secured by a generous public and buttressed by a very vigorous free press.

The sector cannot expect a sympathetic regulator, though it should expect a well-resourced regulator that understands its needs, especially if the sector is faced with the demands of new disclosure standards. In this regard, the Charity Commission for England and Wales (CCEW) has some valuable lessons to teach Australia. The Commission is working towards a standard of disclosure for the sector, and it is assisting the sector and allowing it time to reach an acceptable standard. The Commission’s recent survey of 200 large UK charities assessed the extent to which the charities had gone beyond minimum requirements to provide information that accounted fully and transparently for their performance. The Commissioner (CCEW, 2004a:foreword) concluded: ‘Our evidence is that the general standard of performance against the transparency and accountability framework is not satisfactory. Whilst there are some very good examples, too many charities in our study did not meet basic requirements’. The Commission is working towards a standard of disclosure called ‘Statement of Recommended Practice’, which is to be implemented by March 2005 (CCEW, 2004b).

The CCEW appears to have moved the sector in the right direction, but it is clear that there is still some way to go. A similar reform in Australia would take the resources and impetus for reform that comes with a dedicated regulator. The extra-curricular agenda of the sector, however, needs to be resisted. When the sector cries foul over the possible denial of the freedom to lobby, it is likely suggesting that it would prefer a regulator which, as the price of disclosure, becomes an industry advocate. These matters should not come anywhere near the brief of the regulator; it should not be an advocate, or a friend to the sector. Its role is to protect the taxpayers’ investment in the sector, and the donors’ right to
know. The CCEW in the UK operates in the context of the Labour government’s ‘compact’ with the community sector. Labour used this device to win the hearts and minds of the community sector at the same time as it handed a great deal of responsibility to it for programs paid for by government. The role of ‘partner with government’ was taken up with alacrity by the sector. The difficulty is that ‘partner’ implies something more than a mere contractual partner. For example, the community sector can compete with private-sector providers to deliver services and at the same time have a considerable influence over the nature of the services. The ‘compact’ allows the community sector to act as both advocate and provider, using public funds in both roles.

The roles of advocate and provider are best separated, to the benefit of the government, the sector, and the recipients of the programs. The Australian Labor Party has begun to use the language of the ‘compact’ to win the hearts and minds of the sector, but it falls into the same trap of confusing the two roles of the sector, and the means by which each role should be managed. An Australian charities regulator must apply the agreed standards of disclosure and assist the sector to achieve the standard, but no more than that. The political side, the relationship between the sector and the government, should be handled as it would with any other political lobby.

The CCEW is not a model that should be replicated in Australia. Although it brings knowledge and experience to the job of a regulator, it also comes with the baggage of the sector as a long-standing supplicant to government. For example, four Commissioners manage the Charity Commission, three of whom, including the Chief Commissioner, come from the charity sector. In any context, but especially in the context of the UK government’s policy of a compact with the sector, the selection of Commissioners hopelessly confuses the lines of accountability and fouls the separation required to protect the public’s interest in the sector. The sector’s notion of the public interest is, of course, entirely different from that of the sector’s claim to represent the ‘public interest.’ A Commission should be well informed by the sector, as is the ATO or ASIC, but it should not be a creature of the sector. Indeed, it is questionable whether the resources that will be required by the sector to reach the standards of disclosure recommended should be made available through the Commission. It would be best to have a program of institutional support administered by, for example, the Department of Family and Community Services, and leave the Commission as a regulator without the complication of ‘assisting’ the sector.

**Conclusion**

The Australian government could, as a condition of registration for charity status, impose a national standard of transparency and reporting for charities and establish a new regulator independent of the sector. Resources should be found to assist the sector to attain the required standard, and these resources should not be accessed through the regulator. The charity sector does not need a friend as a
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regulator. It is a sector with many friends in government and many supporters. It
will do it no good to have a regulator acting as an advocate on its behalf as well.

Regulation does not imply a loss of freedom to speak, nor does it preclude a
debate about the proper use of charity funds — for example, for advocacy. The
idea of a powerful disclosure regime is to place much of the work of the scrutiny
of charities into the hands of the donor. The sector will not be defenceless against
the regulator, it is well organised, and has strong links to its donor base and to the
political parties.

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Real Wages and Unemployment: State of the Debate

Tom Valentine

The question of the impact of real wages on employment and unemployment continues to be contentious. A recent example is Bell (2000) in which a number of the essays touch on this question and related policy issues. Unfortunately, many of the essays use questionable arguments to sidestep the question altogether and this approach is consistent with a major strand in the Australian academic literature on unemployment. Therefore, it would be useful to restate the terms of this debate so that the arguments can be embedded in an appropriate framework. The second part of this paper attempts that task.

The third section of the paper examines two examples of sustained high unemployment rates that occurred in Australia in the twentieth century. In both cases, the high unemployment rate resulted from an attempt to improve the income distribution by increasing wage rates. An econometric analysis presented in the Appendix examines the role of high real wages in these experiences. In both cases the focus is on how the economy reacted to a real wage shock, that is, a sharp increase in real wages.

The Debate

The argument that high real wages increase the unemployment rate rests on the simple idea that when the cost of a particular factor of production increases, producers, all other things equal, will reduce the amount of that factor that they use. This impact of a wage increase will be aggravated by any tendency for higher real wages to increase the participation rate. In this sense there is very little to argue about. The one argument that has been made against this general position is that from a macroeconomic viewpoint, an increase in wages also represents an increase in income and therefore, presumably, in aggregate expenditure which would have a positive effect on employment. However, whatever evidence has been presented on this subject (usually in the form of macro-econometric models) has cast doubt on the claim that this effect offsets the direct effect of real wages on employment. One reason for this conclusion is that changing the income distribution against business profits reduces investment and aggregate expenditure and therefore creates unemployment.

Another argument against the significance of real wages in influencing unemployment is the relatively low elasticity of employment to real wages obtained in empirical studies (Junankar, 2000:99). Webster (2003) concludes that estimated elasticities range from –0.15 to about –0.80. Assume that the actual elasticity is –0.50 and that the workforce is 10 million and employment is 9

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million. This means that a 10 per cent cut in the real wage would increase employment by 5 per cent to 9.45 million. However, unemployment is initially 1m (that is, 10 per cent), and will fall by a much larger proportionate amount - to 550,000 (that is, a fall of 45 per cent) leaving aside any change that occurs in the participation rate. It can be shown that the elasticity of the unemployment rate with respect to real wages is equal to the elasticity of employment with respect to real wages multiplied by the ratio of employment to unemployment. In the above example, the elasticity is multiplied by 9, making the elasticity of the unemployment rate 4.5. Note that this calculation assumes that the participation rate is not affected by the real wage rate. In view of these calculations, it not surprising that the econometric estimates reported below indicate that the unemployment rate is very sensitive to changes in real wages.

An alternative way of criticising the view that increasing real wages will increase unemployment is to point out that the market for labour is not a perfect market for a homogeneous commodity in which the price setting process cannot be regarded as a simple auction process (see Junankar, 2000). However, what market can be represented by such a simple model? This sensible empirical observation does not lead us in other cases to conclude that the price of a good (or a closely related set of goods) does not affect the quantity which is purchased. In the case of the labour market, investigators are free to analyse the special characteristics of that market. This analysis often takes the form of the development of special theories to explain certain aspects of the market. For example, the demand for different classes of labour can be examined. One factor affecting the demand for individual labour classes is the elasticity of the demand for the products that they produce which determines the extent to which consumers, rather than the workers concerned, bear an increase in wages. The insider-outsider theory explains how in some cases, unions (insiders) can prevent non-unionists (outsiders) from bidding down wages in their industries. Similarly, the theory of efficiency wages shows that some employers may pay higher wages because they believe that this policy will increase the productivity of their employees. Currently some writers are criticising the large rents being extracted by senior business executives and even by public servants in non-competitive situations. However, none of these special characteristics of the labour market contradicts the general principle that, all other things equal, higher real wages will lead to a higher unemployment rate.

Of course, all things might not be equal. Governments have numerous policies available to them to reduce unemployment and to offset an increase in the real wage. For example, they can provide training programs or they can adjust the structure of social security rules to encourage employment. Most importantly, they can use stimulatory monetary or fiscal policies to increase aggregate expenditure. In particular, they can engage in public works, which directly create jobs. The latter approach has become unfashionable in recent times, but there is no reason to doubt its short-term effectiveness. There seems to be little actual economic analysis behind the ‘surplus fetish’ adopted by both the major political parties in Australia, which inhibits the adoption of public works programs. This
view unnecessarily restricts a government’s flexibility in responding to a recession. There is no reason for a government not to run a budget deficit from time to time. The arguments for ‘public works’ are canvassed in Nevile (2000). Quiggin (2000) goes further and argues for higher average tax rates to finance increases in jobs in the intensive human service sector and infrastructure expenditure. Quiggin’s point that Australia is a low tax country is correct although recent media discussion may make it appear to be controversial. It may well be that the Australian population should reconsider its decision in favour of low taxation and low levels of government services. The effects of governmental neglect of infrastructure are becoming increasingly obvious and there is a good argument for initiatives in this area. However, Quiggin’s suggested taxation reforms certainly need further consideration. Also, specific programs to expand the human services sector may be unnecessary. Wagner’s Law suggests that there is a natural tendency for the supply of government services to increase as national income expands. Henry (2003) suggests that the government share of GDP will increase into the future, but his reasons for this conclusion should be carefully considered.

These arguments have been canvassed by Junankar (2000) in the context of answering the question of whether wage cuts are an effective policy to reduce unemployment. However, many writers concerned with the impact of real wages on unemployment are not advocating wage cuts. Rather they are concerned about the effect of a ‘wages shock’ — a sharp increase in wages with the intention of creating a more equitable income distribution. How the economy reacts to such a shock is analysed in the empirical work reported below. The results suggest that it takes some time for a wage shock to be absorbed and for the unemployment rate to return to its original level.

The policy implications of the relationship between real wages and the unemployment rate depends on the regulatory environment. This point can be clarified by considering two extreme cases:

(i) The government or an independent arbitrator sets a minimum wage rate which is largely reflected in average earnings. In this case it makes sense to talk about wage-setting policy.

(ii) There is no minimum or award wage rate and real earnings are an endogenous variable determined within the economic system. In this case (close to the current situation in Australia) it is not meaningful to talk about a wage-setting policy. However, it may be possible to introduce labour market reforms (such as the introduction of enterprise agreements) that improve employment outcomes. Moreover, more general microeconomic reform (including the adoption of a floating exchange rate regime) might improve the productivity of workers and thereby increase the level of employment.

In order to understand the latter point, it is important to note that, stating the basic principle more precisely, employment depends on real unit labour cost (RULC) rather than the real wage. Now,
RULC = \frac{WxE}{PxRY}

where
- W = average earnings;
- E = employment
- P = the price level
- RY = real output

Therefore,

RULC = \frac{W}{P} \times \frac{E}{RY} = \frac{RW}{PROD}

where
- RW = real average earnings
- PROD = labour productivity

Now,

\frac{d\text{RULC}}{dt} = \frac{RW}{PROD} \left[ \frac{1}{RW} \frac{dRW}{dt} - \frac{1}{PROD} \frac{d\text{PROD}}{dt} \right]

This relationship can be rewritten:

Proportional Increase in Real Unit Labour Costs = Proportional Increase in Real Wages – Proportional Increase in Productivity

Therefore, any reform that increases productivity will reduce RULC and, other things equal, will lead to employment growth. Australia had a strong productivity performance over the last two decades of the twentieth century, but this led to only a modest fall in RULC because most of the increase in productivity was passed on in higher real wages. This is indicated by the following equation for the period 1981 to 2001.

\Delta\%RW = -0.303 + 1.037\Delta\%\text{PROD} \quad \bar{R}^2 = 0.295 \\
(0.45) \quad (3.06**) \quad d = 2.15

where
- \Delta\%RW = percentage increase in the real wage
- \Delta\%\text{PROD} = percentage increase in labour productivity
- \bar{R}^2 = the adjusted coefficient of determination;
- d = the Durbin-Watson statistic;

values under the coefficients are t-values; and asterisks indicate degrees of significance (one indicates significance at the five per cent level and two significance at the one per cent level).

The wage variable used in the above equation is the total compensation of employees divided by the number of employees. It therefore includes non-wage costs such as compulsory superannuation contributions. Freebairn (2003) shows
that the impact of the Superannuation Guarantee Charge on employment and wages depends on its impact on labour supply, which in turn depends on the extent to which workers regard the superannuation payment as a substitute for a wage payment. The coefficients in this equation are very stable over the estimation period. Wooden (2003) presents evidence to show that prior to 1996 workers tended to supplement their earnings by increasing their hours of work in one way or another. After 1996, they were able to obtain wage increases in line with increases in productivity because of the extension of enterprise bargaining. The measures of earnings and productivity used in the above equation do not take account of changes in the average hours worked by workers. Therefore, the results provide some support for Wooden’s hypothesis.

Productivity has been defined here as output per worker. Productivity in this sense will be increased by investment, which increases the amount of capital per worker. In some periods wages have been increased in line with the change in productivity, which some commentators argue is an equitable way to fix wages. If this is done, unit labour costs will be unchanged and consequently the price level and real unit labour costs will also be unchanged. Therefore, there will be no wage effect on the unemployment rate (that is, the increase in the amount of capital will not reduce the unemployment rate). It should be noted, however, that this conclusion depends on the assumption that the unemployment rate depends on real unit labour costs and that the price level depends on unit labour costs.

Moreover, the return on capital remains constant. As Valentine (1993) points out this may reduce the incentive for investment (which would increase national income and therefore reduce the unemployment rate) relative to the situation that would exist if wages were market determined.

The effectiveness of microeconomic reform has been criticised by some of the authors in Bell (2000), particularly Gregory (2000), by comparing the performances of countries that are deemed to have undergone significant reform with those of countries which have experienced less change. This approach creates inappropriate counterfactuals. It takes no account of the other factors affecting the performances of the various countries and does not adopt the normal approach in economic research of attempting to remove the effects of other variables before considering the relationship between two variables. It is interesting that economists of the School represented in Bell (2000) often cite the success of the Norwegian economy as an example of a country that has successfully withstood deregulation without mentioning the word ‘oil’. Quiggin (2000:221) does modify his view of the Norwegian success (as compared with the performance of Sweden which has undergone considerable reform) by throwing in the phrase ‘partly because of the availability of revenue from North Sea oil’, but he pays no further attention to this significant variable.

Also, the approach ignores the initial conditions for the countries involved in the comparisons. In particular, countries will often undertake fundamental economic reforms only when they are already in serious economic difficulties. The only appropriate counter-factual (although a difficult one to create) is what would have happened to the country if the reforms had not been introduced. Also,
reforms do not have an immediate effect and the time elapsed needs to be considered.

Parham (2002) argues that Australia experienced an increase in the rate of productivity growth of over 1 percentage point in the 1990s. He attributed this increase to microeconomic reforms. Quiggin (2001) argues that the productivity gains have been exaggerated although his estimates still indicate some productivity gains. Quiggin (2001) quotes Krugman (1998) as describing ‘Australia as the “miracle economy of the financial crises”’, but argues that this comment referred to macroeconomic management rather than microeconomic reform. However, macroeconomic management includes the floating of the Australian dollar which has had an important effect on the competitiveness of the Australian economy.

Two Examples of High Unemployment

There were two major bouts of unemployment in Australia in the twentieth century, specifically in:

- the thirties (the Great Depression); and
- the last 25 years of the 20th Century.

In both cases the analysis can proceed in terms of wage-setting policy. As will be seen, in both cases the relevant authorities increased award wages sharply and this led to an increase in real unit labour costs. The result was higher unemployment.

How does the economic system react to this increase in award wages? The natural reaction is for prices to increase so that the real wage and real unit labour cost return to their original level and the unemployment rate returns to something close to its original level. Under this view prices are set as a mark-up over labour costs.

However, this adjustment process is retarded by a number of factors. First, there is a long lag in the adjustment of prices to changes in unit labour costs. Secondly, the extent to which prices can be increased depends on the strength of aggregate demand. The high unemployment rate created by the initial wage shock will create an environment unfavourable to increasing prices. Thirdly, monetary authorities are likely to institute policies which contain inflation, that is, prevent the price changes that are necessary to allow the economic system to adjust to the changes in wage levels.

The workings of the adjustment process are illustrated by the econometric models reported in the Appendix. The results can be summarised as follows:

- in both cases, the economy had a ‘real wage overhang’ at the beginning of the period;
- there is a significant lag in the reaction of prices to changes in wages; and
• in the earlier period, increases in wages (unit labour costs) are not fully reflected in prices and in both cases, the effect of the increase in real wages has not worked off by the end of the period.

It has to be recognised that the outcome of an increase in real wages depends on the environment in which it occurs. Specifically, it depends on the institutional and regulatory structure of the economy, the stance of monetary and fiscal policy, the exchange rate regime and the strength of exports. The first influence may explain why the models for the two periods include different equations. A further explanation is the difference in data availability. Also, there is a possibility that the reaction of the economy to a change in wages depends on its size or its sign. This second question has not been investigated in the econometric analysis presented in the Appendix. These possibilities provide opportunities for future research.

Conclusion

The discussion of policies on unemployment needs to be adapted to the environment in which the discussion is taking place. If the authorities have an important influence on average earnings by fixing minimum (or award) wages, it makes sense to discuss the merits of alternative wages policies. If earnings are determined endogenously, other policies need to be considered. Such policies include those directly targeted on unemployment, but they should also include general measures of economic reform. Employment creation is one of the aims of microeconomic reform and we need to analyse its successes or failures in this area. It is not sufficient to simply reject it on the basis of a few general and unsoundly based comparisons.

The econometric results discussed in the Appendix to this paper show that when the authorities can control wage rates, they need to be very careful to ensure that this control is not used to create unemployment. Specifically, attempts to modify income distribution by sharply increasing wage rates are likely to lead to a higher unemployment rate and to be eroded over time by increasing prices. These results are relevant in the evaluation of any proposals to return to a centralised system of wage fixation.

Appendix

The Depression Experience

In 1920, 1921, 1922 there were sharp increases in minimum wages, which carried through into average weekly earnings. In part, this increase was based on past inflation, but it overshot the amount necessary to provide adequate compensation for the earlier price increases. RULC increased by over 20 per cent between 1918-19 to 1921-22 and remained at that higher level over the nineteen twenties.
This means that Australia had a ‘wages overhang’ (an accumulation of wage increases in excess of productivity gains) in the nineteen twenties and this overhang was carried through into the depression period. This conclusion contradicts that of Gregory, Ho and McDermott (1988:244) that ‘real wage gaps’ were not relevant to explaining unemployment during the depression.

The adjustment process is represented by the econometric model in Table A.1. The data used in estimating the model was obtained from Butlin (1977). The first equation explains the unemployment rate in terms of the real average wage rate and real gross national product. The second equation explains the price level as a mark-up over unit labour costs. However, the mark-up is a function of the strength of aggregate demand. In this case aggregate demand is measured by the unemployment rate itself. Both equations include a lag in adjustment. The model explains the unemployment rate rather than employment because determining a variable in a model as the difference between two other variables can lead to large errors.

The equation for the unemployment rate includes a time trend to account for the effect of technological progress on employment and the unemployment rate. Not surprisingly, its coefficient is positive in both models.

Most of the variables used in estimating this model are integrated to order 1. In these circumstances any estimated relationship could be spurious. However, there may be a co-integrating relationship amongst the variables, that is, a long-term relationship in which the estimated residuals are integrated of order zero. There are a number of approaches to this problem (see Davidson and Mackinnon, 1993:Chapter 20), but the one adopted in this paper is to test the residuals for the presence of a unit root (that is, to ensure that they are of order zero). This was done by using the Augmented Dickey-Fuller statistic, but with significance levels taken from Table 20.2 of Davidson and Mackinnon (1993), which applies to regression residuals. For both the estimated equations we were able to reject the null hypothesis that the residual series contained a unit root.

The first two equations in Table A.1 have been estimated by the Seemingly Unrelated Regressions (SUR) technique, which uses the correlation between the errors in the equations to improve the efficiency of the estimates.

In this case the correlation coefficient of the residuals in the equations is 0.342 indicating that efficiency gains were achieved by using the SUR estimator. Dummy variables have been included to remove some outliers amongst the regression residuals. These outliers could have arisen from problems in the original data.

The price equation shows that prices do increase when unit labour costs increase but that the reaction of prices is subject to a significant lag and adjustment is retarded by the reduction in demand as reflected in the unemployment rate. Moreover, the long-run elasticity of prices to unit labour costs (0.852) is significantly less than unity.
Table A.1: A Simple Model of Unemployment 1900-1939

\[
\begin{align*}
\log \text{UR} &= 40.63 + 0.471 \log \text{UR}_{-1} + 2.396 \log (\text{AWE}/P) - 4.627 \log \text{RY} \\
&\quad + 0.0804t - 0.520D_{08} + 0.779D_{13} + 0.522D_{25} \\
R^2 &= 0.909 \\
(9.24**) &\quad (6.97**) &\quad (6.41**) &\quad (9.05**) &\quad d = 1.83 \\
\log P &= 0.719 + 0.411 \log P_{-1} + 0.502 \log \text{ULC} - 0.00479\text{UR} \\
&\quad + 0.120D_{17181920} - 0.0836D_{30} \\
R^2 &= 0.989 \\
(6.78**) &\quad (4.90**) &\quad (6.96**) &\quad (4.45**) &\quad d = 1.47 \\
\text{ULC} &= (\text{CE} \times \text{AWE}) / \text{RY} \\
\text{CE} &= \text{WF} \times (1 - \text{UR}/100)
\end{align*}
\]

**Variables**
- AWE = average weekly earnings
- CE = civilian employment (minus defence employment)
- D08 = 1 in 1908; 0 otherwise
- D13 = 1 in 1913; 0 otherwise
- D17181920 = 1 in 1917, 1918, 1919 and 1920; 0 otherwise
- D25 = 1 in 1925; 0 otherwise
- D30 = 1 in 1930; 0 otherwise
- P = implicit GDP deflator
- RY = GDP at constant prices
- t = time trend
- ULC = unit labour cost
- UR = unemployment rate
- WF = workforce

Figure A.1 indicates the results of various dynamic simulations of the model in Table A.1. UR is the original series and UR* is the result of a dynamic simulation of the model using the original data. This is a test of the model’s ability to track the economy. The correlation between UR and UR* is 0.920, indicating that the model gives a good explanation of the data.

UR** is the result of a dynamic simulation in which AWE was reduced by 10% over the period 1920 to 1939. Up until 1919 the values of UR* and UR** are the same. It is clear that this reduction in wages would have substantially lowered the unemployment rate in both the nineteen twenties and the nineteen thirties. Also, the effect of the reduction was not exhausted, even at the end of the thirties.

The conclusions are similar to those produced by the econometric model in Valentine (2003).
Unemployment 1980 to 2001

Table A.2 presents an econometric model of the unemployment rate for the period 1980 to 2001. It describes how unemployment reacted to wage changes over that period and the large initial wages overhang that had been created in the nineteen seventies and is similar to the model used in Valentine (1993).

The model includes an equation explaining profits (gross operating surplus) so that the impact of wage changes on different components of GDP can be taken into account. This is consistent with the view that governments attempt to change wage rates as a way of making income distribution more equitable. The GDP identity also fulfils the requirement of Webster (2003) that demand should be endogenous. Participants in the debate on the effect of real wages on the unemployment rate often refer to the impact of wages on aggregate demand. In particular, it is sometimes argued that an increase in wages increases aggregate demand and therefore has a minimal effect on unemployment. All other things equal, an increase in wage rates will increase aggregate wages, but it is also likely to reduce profits. Also, it should be remembered that the ultimate impact of an increase in wage rates on aggregate wages depends in part on the impact of the change on employment.

In pre-analysis of the data it was found that most of the series were integrated of order one in levels, but integrated of order zero in first differences. The price variable is an exception. It comes closest to being integrated at level zero in level terms (the hypothesis of the presence of a unit root is only just accepted at the 10 per cent significance level).
These results led to the adoption of the following strategy. The equations for the unemployment rate and gross operating surplus are estimated in first differences while the price equation is estimated in level terms. In addition, the residuals of all three equations have been tested for the presence of a unit root using the significance levels given in Table 20.2 of Davidson and Mackinnon (1993). In all three cases the hypothesis of the presence of a unit root is clearly rejected.

A number of writers have suggested reasons for an unstable relationship between the unemployment rate and real wages. They include:

- Henry (2003) who pointed out the growing number of government support recipients who are Disability Support Pensioners and who therefore are not counted as unemployed. Gregory and Cai (2003) made the same point;
- Wooden (2003) who argued that enterprise bargaining has led to increasing productivity being passed onto workers in the form of higher wages and this means that a change in earnings might not have the same effect on unemployment; and
- Gregory and Cai (2003) who pointed out that there has been a shift from full-time to casual employment in the workforce. Again, this means that a given increase in average earnings has a different effect on recorded unemployment.

However, the coefficients in the equations reported in Table A.2 are very stable and there is little evidence of instability in the relationships.

Table A.2 omits various identities used in the actual calculations, specifically those relating:

- changes in variables to the levels of those variables; and
- the values of variables to the logarithms of those variables.

Once again the equations have been estimated using the SUR estimator. The correlation matrix for the residuals in the three equations is:

\[
\begin{array}{ccc}
\Delta \log(UR) & 1.000 & 0.064 & 0.441 \\
\log(P) & 0.064 & 1.000 & -0.194 \\
\Delta \log(GOS/P) & 0.441 & -0.194 & 1.000 \\
\end{array}
\]

This matrix shows that some gains in the efficiency of the estimates have been achieved.
Figure A.2 reports the results of dynamic simulations of the model given in Table A.2. UR is the actual value of the unemployment rate and UR* is the value obtained from a dynamic simulation of the model using the actual variables. Although there is a slight tendency to overestimate UR, the model tracks its movements very well. The correlation coefficient between UR and UR* is 0.958.
UR** shows the effect of increasing wages by 10 per cent over the period. In this case the immediate effect is a reduction in UR because of the positive effect on income.

However, this positive effect is reversed the following year and for the remainder of the period UR is higher. Once again, the effect has not worn off by the end of the period. This outcome arises from similar sources to those identified in the previous subsection (although in this case the long-run elasticity of prices with respect to ULC is not significantly different from unity), but in addition there is a negative impact on profits, which reduces income and, therefore, increases the unemployment rate.

Figure A.2: Simulations of a Model of Unemployment 1980-2001

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Applying Conditionality to Development Assistance

Roland Rich

The announcement on 6 May 2004 by the Millennium Challenge Corporation (MCC) of the 16 countries eligible to receive funding under the Bush Administration’s Millennium Challenge Account (MCA) is a key step in the process of determining the direction of development assistance by applying quantitative international comparators to the governance performance of developing countries. It is the latest in a series of conditionality strategies aimed at making aid ‘effective’. It is also the most sophisticated in terms of quantification of the eligibility conditions, giving the impression that the direction of aid flows has moved into a scientific direction of applying solid statistical information in a formulaic manner, thus making the system both transparent and reliable. The MCA process has the advantage of learning from previous experience, but whether it will be able to ‘solve’ the problem remains in doubt.

This paper looks at the context for this initiative by tracing some of the key historical episodes shaping development assistance in an attempt to understand the increasing reliance on conditionality. A broad taxonomy of conditionality is proposed. The paper also examines the MCA process to date, looking at the growth of, and reliance on, statistical comparators as the critical decision-making tool. It concludes with some thoughts on the place of conditionality in development assistance and the place of statistics in conditionality.

It is not within the aims of this paper to comment on, or attempt a measurement of, the effectiveness of aid. This is one of the big questions in development assistance. Recent work demonstrates the need for far greater care in tackling this issue and, in particular, the need to disaggregate emergency aid, institution-building aid delivering benefits over the longer term, and aid intended to stimulate growth in the shorter term (Clemens, Radelet and Bhavnani, 2004). While the debate on aid effectiveness continues, the working assumption in the development assistance community is that improvements in direction and delivery are necessary. Conditionality continues to be a key part of the formula.

Inventing Development Assistance

The ‘invention’ of official development assistance (ODA) flowed from the success of the Marshall Plan, which has been described as the largest and most successful aid package in history, in which SUS 13 billion was spent after WWII by the United States for the reconstruction of the infrastructure, policies and governance.
processes of a devastated Europe (Sanjana, 2000:2). While the Marshall Plan is remembered for its generosity, it has been described by Waller (1994) as accompanied by a form ‘severe conditionality’. Every country benefiting from American assistance had to sign a bilateral agreement binding it to balance budgets, restore financial stability and stabilise exchange rates at realistic levels, as well as to set aside counterpart funds from government budgets and put them at the disposal of the American administrators to underwrite further investment (Hogan, 1985).

The Marshall Plan ‘proved’ that ODA worked, and all that was needed was a theory to explain the process. Curiously, the theory and the subsequent early practice did not draw on any of the realities of the Marshall Plan, such as the importance of policy settings, counterpart funds or conditionality, and instead relied on Evsey Domar’s theory — a simplistic and soon disowned idea that ‘GDP growth will be proportional to the share of investment spending in GDP’ (Easterly, 2001). Poor countries cannot put aside sufficient savings to invest in capital, but if an outsider could fill this ‘financing gap’ and spend the required money on capital works and productive machinery, the reward would be a correspondingly higher rate of economic growth. One can perhaps understand how political leaders in the 1950s fell prey to such a simple model. It seemed like a good investment to turn millions of poor people into middle class consumers of American products; the romance of technology as panacea was in its naïve infancy; Domar’s theory had an unsophisticated and compelling clarity; and the concept of ODA had a pleasing Good Samaritan ring to it.

Fifty years of ODA practice have demonstrated the complexities masked by Domar’s simplistic theory. In the process of refining ODA, conditionality in various forms has made its way back to centre stage, though it has not always been labelled as such.

**Embedded Conditionality**

Donor values are embedded in ODA. In the minds of the donors these are the values of successful societies whose economic and political achievements qualify donor experts and legitimise their values. The inculcation of donor values is rarely put in the form of overt conditionality. It is simply part of the package, and it is usually not articulated by the donor or perhaps even understood as embedded in the process. All aspects of the ODA phenomenon, from choice and design of projects to delivery and evaluation, have the imprint of donor values.

Some values such as the elimination of discrimination against women can be seen as universal. Donors refusing to provide aid for local systems that educate only boys may set in train a process whereby decision makers in the recipient society re-evaluate their own values. Few would take issue with a process of values transfer promoting universal values against racial or gender discrimination. Promoting universal human rights through the aid program is a corollary of the emergence of human rights in international relations as a legitimate issue of international concern.
Other values are far more culturally and politically specific. A recent example can be seen in President Bush’s National Security Strategy released on 20 September 2002 (see http://www.whitehouse.gov/nsc/nss.html), in which he states that ‘we will use our economic engagement with other countries to underscore the benefits of policies that generate higher productivity and sustained economic growth’. One of those policies is ‘lower marginal tax rates’. This is clearly going beyond the bounds of promoting universal values.

The problem of identifying embedded values often lies in the grey area between universal values and specific national values. It often arises in the way projects are delivered. The different styles of leadership, consultation, discussion, hierarchy and the way credit is claimed are often the friction points between donors and recipients. Donor values of individuality, punctuality and succeed-at-all-cost often conflict with local values. A mundane but telling example is the loss of momentum in a project when meetings must be postponed because a key local participant attends the funeral of someone the donor project deliverer considers to be a ‘distant relative’. Differing notions of family, social responsibility and work ethics are at play. The aid expert and the foreign investor in these circumstances are urging their counterparts to adopt a new set of values.

The process of values transfer is based on an assumption that the values being promoted are best for the recipients. Many of the values being promoted are indeed often beneficial. No society is static, and all societies develop by learning from others; values transfer is as natural as the transfer of technology. The important point about values transfer in the ODA process, however, is that the values come attached to, or embedded in, the aid. Poor recipient countries wish to attract financial and technical assistance from rich powerful donors, and thus have little option but to accept the accompanying values, often in spite of doubts as to their suitability. These values may not necessarily fit well into the recipient societies, and the social or cultural costs of achieving ‘success’, as perceived by the donor, may not be apparent to, or may even be masked from, the recipient.

The flow of values is also pretty much one-way. ‘What do you think of the idea of our Peace Corps?’ President John Kennedy once asked Prime Minister Jawaharlal Nehru. ‘A good plan’, Nehru answered, ‘young Americans can learn a lot from Indian villagers’ (International Herald Tribune, 1999). Nehru’s response was entirely appropriate, as a later generation of western backpackers would learn, but the humour in the exchange speaks eloquently of the underlying assumption about which group has the knowledge and the power.

**Contractual Conditionality**

The most widely practiced form of contractual conditionality is in the preconditions laid down by lenders such as the IMF. As noted, this form of contractual conditionality has its origins in the severe conditionalties of the Marshall Plan. There is a significant economic literature dealing with this form of conditionality, which has been defined as ‘a mutual arrangement by which a government takes, or promises to take, certain policy actions, in support of which
an international financial institution or other agency will provide specified amounts of aid' (Killick, 1998:6). The two points that should be made in relation to contractual conditionality concern the iterative process of designing conditions, and the quality of the recipient agreement to those conditions.

Conditions imposed by the IMF and other international financial institutions have evolved over the years reflecting changes in economic theory as well as lessons learned from previous experience. Conditions concerning demand restraint and interest rates were soon enlarged to cover government expenditure and public sector employment, then began to deal with opening up the economy to greater competition, and finally, currently, to deal with the design and practices of the institutions of government. It follows that the borrowing nations have been the guinea pigs in this vast economic experiment.

The experimentation has followed economic fashion in the donor countries, regardless of its relevance to the developing world. Thatcher/Reagan era ideas about the desirability of small government are still with us, together with their accompanying mantras of deregulation, privatisation and outsourcing. These ideas became fashionable when many developing countries were still coming to terms with the previous focus on ‘nation building’, including strong executives, rigorous revenue collection regimes, and the leading role of the state in societies with small private sectors. The latter ideas were widely accepted when economists admired the concept of the development state, but the new fashion of small government has now replaced this — although recent corporate excesses in the United States may lead to a greater emphasis on regulation and the necessity for a strong bureaucracy of accountability as the next swing in fashion. This is not to ascribe bad faith motives to the IMF and others, but it does raise the question of the ethics of externally designed policy prescriptions when the designers do not personally experience the fallout from the possible failure of these policies.

This leads to the question of the quality of the agreement of the borrowing country. Formally, the borrower has accepted the conditions laid down in the loan agreement. The agreement is usually a document of treaty status. It is a public document. The financial markets carefully examine it, and adherence to it becomes one of the key barometers of the credit rating of the borrowing country. There may be cases when local political leaders, accepting the necessity of austerity policies, will prefer to portray these as imposed by the lender — in the hope of finding an outside target for the anger the policies generate. The problem is that the bargaining room of the borrower is extremely limited. If it does not want the conditions imposed it can borrow from the private market. But the borrower economies are often in so parlous a state, as Soeharto found in 1998, that private loans have dried up and the IMF becomes the lender of last resort.

Here lies the weakness in the contractual conditionality system: the conditions are not locally owned, but are seen as imposed from outside. In a recent report, the World Bank (2001) accepts that “without such ‘country ownership’, external cajoling and or donor-imposed ‘conditionality’ are unlikely to make poor countries adopt reforms which they oppose”. Ownership of reforms is therefore becoming a key determinant of the success of development projects.
Applying Conditionality to Development Assistance

and programs, a point to which this paper returns. The ownership has to go deeper than the leadership of the developing country. It must include some at least of the elite. But full ownership can only come about through a discursive and deliberative process involving the people affected by the policies. There is no single formula for the process of gaining ownership of policies. Some policy decisions may well be left to the bureaucrats if there is a vigilant media alert to the issues. Others may require the more formal processes of democracy, whereby the electorate can own the decision through its vote.

Democracy is also a factor in the donor countries. ODA is public money, and public money requires proper accountability, so one form of contractual conditionality that will continue to be employed involves audit and oversight conditions to ensure the money is spent as agreed. The sentiment of the electorate in the donor states also comes into play in the process of negative conditionality.

**Negative Conditionality**

Negative conditionality in ODA, as a calculated attempt to influence a specific policy, seems to have had its genesis in the Dutch decision of 1990 to suspend a part of its aid program to Indonesia in response to the execution of four political prisoners (bodyguards of President Sukarno who had already spent some 25 years in prison). Such executions had been a feature of Soeharto’s regime and regularly drew protests, to the point that these had become rather ritualised. The suspension of an aid program, as a direct and articulated response to a perceived abuse of human rights, was a new development, and elicited much comment in the media and among diplomats. Whether as a consequence of this initiative or not, the executions of 1965 era prisoners in Indonesia ended thereafter (Glassius, 1998).

Here then, it would appear, was a direct and effective means of influencing policy that seemed to be less confrontational and politically easier to employ than sanctions. But within two years, in response to the Dili massacre in 1991, the suspension of Dutch aid programs, as well as some of those of Denmark and Canada, brought a far more belligerent response from Jakarta. Indonesia announced the refusal of all aid from the Netherlands, while at the same time announcing an internal inquiry into the massacre. The Netherlands and Indonesia quietly mended fences in 1992 and the aid relationship resumed (Glassius, 1998).

An important precedent had been set, in that aid and human rights had been linked through this form of negative conditionality. Since that time the concept of negative conditionality has been refined, and its most formal expression is in the aid relationship between the European Union (EU) and its African, Caribbean and Pacific recipients, who recently concluded a twenty-year Partnership Agreement in which respect for human rights, democratic principles and the rule of law are essential elements. Parallel to the multilateral negotiations, the EU adopted a policy of including democracy clauses in its various bilateral agreements making democracy and human rights part of the bilateral dialogue. More pointedly, the recent bilateral treaties regard serious and persistent human rights violations and serious interruptions of democratic process as a ‘material breach’ of these bilateral
treaties. Article 60 of the Vienna Convention on the Law of Treaties states that ‘a material breach of a bilateral treaty by one of the parties entitles the other to invoke the breach as a ground for terminating or suspending its operation in whole or in part’. The EU has thus armed itself with the power at international law to suspend or terminate bilateral aid agreements in the event of human rights abuses or extra-constitutional attacks on democratic government (EU, 2000).

Suspension of EU aid for non-respect of democratic principles and interruption of the democratic process has occurred in at least ten cases: Niger, Sierra Leone, Togo, Cameroon, Haiti, Comoros, Cote d’Ivoire, Fiji, Liberia and Zimbabwe (Santiso, 2002). Each case has its own particularities, making generalisations about the effectiveness of the suspension mechanism difficult. One broad conclusion is that this weapon is blunt and difficult to wield with any precision. The EU has embarked on its own learning curve to determine ways of calibrating the tool to particular circumstances. Negative conditionality works poorly in weak or failing states, and can have the effect of reducing even further the legitimacy of the state — thus making the solution to the problems more elusive. Haiti provides an example where the EU basically dealt itself out of the process by suspending the means through which it previously exerted some influence. Negative conditionality seems to work best when allied to internal forces working for the restoration of democracy. It thus strengthens the hand of those forces by giving them leverage they would not otherwise have. Fiji’s eventual return to constitutionality after George Speight’s coup in 2000 may be seen in part as a response to pressure from an alliance of international forces together with civil liberty groups and, importantly, local exporters who understood that Fiji’s preferential access to European garment markets would otherwise be lost (Robertson and Sutherland, 2001:105).

Perhaps the best example of negative conditionality leading to virtual pariah status as far as aid is concerned is the donor community’s relationship with Burma. With the exception of small humanitarian and training projects, aid to Burma flows not to the military regime but to the dissident community on its borders and in foreign states, which constitutes an expression of the unacceptability of the rejection by the military of the popular mandate won by the National League for Democracy (NLD) in 1990. Over a decade of aid suspension has not brought an end to the military dictatorship in Burma, but it may have strengthened the hand of NLD’s leader, Aung San Suu Kyi.

Negative conditionality may include an element of punitive conditionality. While the former is guided by the wish to influence domestic development policy, the latter may contain rhetoric to this effect but is actually intended as a political response in the form of punishment. A good example of punitive conditionality was the western response to the Vietnamese invasion of Cambodia in 1979, ending the Khmer Rouge genocide. Although a strong argument could have been made that this was a valid and effective exercise of the doctrine of humanitarian intervention, the politics of the situation required a Cold War response, including the suspension of aid.
The literature tends to the view that negative conditionality does not often bring the desired result (Santiso, 2001:8). The Dutch experiment in 1990 raised hopes that suspension of ODA might be a simple process to trigger respect for human rights and democratic principles, but subsequent experimentation has shown that the process is rather complex. Many other factors need to be taken into account. A further response has come in the form of positive conditionality.

**Positive Conditionality**

‘We must tie greater aid to political and legal and economic reforms. A USD5 billion annual increase … will be devoted to projects in nations that govern justly, invest in their people and encourage economic freedom’. President George W. Bush made this announcement in Monterrey on 22 March 2002. Support for positive conditionality has been echoed by the Australian Prime Minister, John Howard, though without an announcement of significant new funds for ODA:

Any country that has a role in providing help to countries that need help has a right to see that that help is most effectively used, and it’s certainly the view of the Australian public that aid should be given on the understanding that it’s used in a sensible and effective fashion, and we have our sovereignty as well and we have a perfect right to say to a country ‘well we will provide aid but in return we would like certain standards of governance to be met and that’s our philosophy’ and I think it’s a very understandable philosophy. It’s also, incidentally, the philosophy of the European Union in relation to Africa, and the Pacific should understand that what is happening in Africa under NEPAD (New Partnership for Africa’s Development) now, is that governance and aid have been linked (Howard, 2002).

This thinking flows from a sober realisation that many aid practices have simply not brought results. The World Bank (1998) called for a systematic targeting of aid to countries with sound policies and effective institutions. It thus encouraged the donor community to link aid to performance, not to promises. This argument has had considerable impact. It has led to a significant shift in the type of aid flowing to developing countries. Donors are now wary of large infrastructure projects. Projects building roads, dams, irrigation schemes and bridges are becoming less popular than they once were. Apart from the problems of corruption that can creep into these large projects, they have come to be seen as secondary in the development process, the primary requirement being good institutions of governance and good policies. Accordingly, aid flows for governance projects have grown considerably. Aid for ‘social and administrative infrastructure’ is now the largest category of aid spending, accounting for over 40 per cent of OECD aid in 2000, and within that category almost half is devoted to ‘government and civil society’ (OECD, 2001).
Positive conditionality can also be seen as selectivity. It is selectivity not only in the choice of aid projects, but selectivity in the appreciation of policies in developing countries that attract those aid projects. Burnside and Dollar (1997) and Devarajan et al. (1997) argue that selectivity is in fact not directly related to good policies but rather it is based on other more political considerations. The correct policy package is difficult to gauge for each developing country, given differing histories and capacities. Collier et al (1997) note that this has led instead to the idea of measuring not policies but outcomes, and tying aid to progress in outcomes such as a fall in child mortality or a certain rate of economic growth. Measuring outcomes is also problematic, however, even if one has confidence in the developing country’s statistics. Outcomes are dependent on many factors, and basing aid on outcomes may lead to penalising a country that has missed its targets because of conditions it cannot control, such as drought. Outcomes do not measure quality (for example, unsustainable use of natural resources may lead to higher economic growth). Nevertheless, outcomes are measurable, and increasingly sophisticated processes can be designed to factor in the qualitative aspects.

Positive conditionality can lead to its own distortions. The holding of free and fair multi-party elections is a common condition set to bring positive rewards. Donors then have a strong interest in achieving this result virtually ‘at any cost’. The 1994 Mozambique elections cost USD64.5million, virtually all of which came from donors, representing 4.4 per cent of GDP. Similar amounts were spent in transition elections in Nicaragua and Ghana (Ottaway and Chung, 1999:102). Good outcomes were achieved, but at unsustainable costs. Can ODA processes thus lead to outcomes where more is spent on elections than on education?

Directing whatever influence aid generates to the improvement of government policies and processes through positive conditionality is worthwhile even though it is not without problems. It is part of the process of transferring policies and processes aimed at increasing accountability, transparency, competence and participation in government decisions. Much of the aid effort is now directed at this process, but question marks remain. Even leaving aside problems of subjectivity, politicisation and inconsistency, there is the problem of a lack of commitment to the policies being transferred. The solution to this fundamental problem has been summarised in one word: ‘ownership’.

Democratic Conditionality

And finally, I talk of ownership, ownership as an essential element in this development process; ownership as a result of knowledge transfer, ownership as a result of opportunity, ownership as an essential element because no one wants to be told what to do from the outside. It is simply not effective to get nominal acceptance of programs. Key is that the programs should be owned and developed by the people who are in development. This is a form of democracy; a form of political movement in a sense. But it is also an economic issue, because with ownership, you get results (Wolfensohn, 1999).
World Bank President James Wolfensohn is here articulating a truism that has taken the development assistance community half a century to come to grips with. Ownership goes well beyond the formal acceptance of development assistance or even the signing of an agreement to its terms; it is about the policies and ambitions of the leaders of developing countries and their people. If ownership is a key requirement, then the absence of ownership of programs and policies by recipient polities will be a disabling feature. Kofele-Kale (2000:151) has put the absence of ownership in quite graphic terms, arguing that ‘because African leaders were dragged kicking and screaming into the governance and democratisation reform movement, their commitment to it is, at best, questionable. They cannot, therefore, be counted on to carry through to their logical conclusions the reforms called for’.

Here then lies one of the great dilemmas of the process of development assistance: the imposition of the institutions of democratic governance through processes of conditionality is unlikely to be effective, yet, in the opinion of this writer, without democratic governance there is unlikely to be sustainable development. The factors favouring the imposition of conditionality may be politically popular in the donor community, but that does not make them effective instruments of policy. ‘Conditionality cannot substitute or circumvent domestic ownership of and commitment to reform’ (Santiso, 2001).

One response to this dilemma is to contribute to the process of domestic commitment to reform and democratisation. Di Palma (1990) has described part of this process as the diffusion of democracy. The processes of diffusion include example, persuasion and the progressive development of universal norms favouring democratic governance. An important step in this process was the argument by Amartya Sen (1999:5) that democracy, though perhaps not yet a universal norm, had become a universal value — ‘while democracy is not yet universally practiced, nor indeed uniformly accepted, in the general climate of world opinion, democratic governance has now achieved the status of being taken to be generally right’. This general climate of opinion encourages the view that democracy is not the preserve of the rich countries, but is as valid a form of governance for developing countries.

The process of diffusion need not be passive or evolutionary. The broad field of democracy assistance may be seen as an active means of favouring diffusion by delivering the message of the benefits of democratic governance as widely as possible. One of the major targets is the ruling elite, but diffusion needs to go well beyond this narrow group interested in protecting the status quo. The political opposition may be an ally in some circumstances. The de facto veto over the aid programs of most donors held by Aung San Suu Kyi is a form of ownership. Burnell (2000) calls this form of influence ‘coercive conditionality’.

One of the most important understandings in ODA has been the realisation of the need for the diffusion of values to target groups aside from governments, and thus to focus on civil society. This is an attempt to develop a mass base for democratic reform by bypassing ruling elites and attempting to reach a different elite, the leadership of civil society. All donors have recently concentrated greater
resources on civil society. Usually the recipients are local NGOs in fields such as health and education, but some donors also support civil society advocacy groups.

Ownership, whether by a government committed to democratic reform, or by an opposition with some form of democratic legitimacy, or by acknowledged local civil society leaders, helps to deal with another democratic conditionality paradox: its fundamentally undemocratic nature. Santiso (2001) describes this perverse effect, noting that conditionality ‘undermines the domestic processes by supplanting public policy-making’. So some form of ownership of local policy-making is necessary, though at times it may lack the formality of political party platforms endorsed in elections. The more authoritarian the society, the more difficult it is to engage in a public deliberative process indicative of local views.

Democratic processes therefore have a central place in making political conditionality effective. One of the three values Sen (1999) sees in democracy beyond its intrinsic and constructive values is its instrumental value, whereby people have a voice and can direct political attention to specific issues. Democracy’s instrumental value is crucial in making economic and social policy effective. This is perhaps where the once popular concept of the development state is at its weakest; the absence of an instrumental role for democracy proved to be the Achilles heel that ultimately caused its unsustainability. Whether imposed by an autocrat or by an outside donor, policies that do not have broad local ownership are unlikely to succeed.

**Applying Positive Conditionality**

Two years after the Bush announcement in Monterey setting out the adoption of a positive democratic conditionality policy, an initial amount of SUS 1 billion was voted for this policy for the 2004 fiscal year, and on 6 May the MCC announced the list of eligible countries as ‘including Armenia, Benin, Bolivia, Cape Verde, Georgia, Ghana, Honduras, Lesotho, Madagascar, Mali, Mongolia, Mozambique, Nicaragua, Senegal, Sri Lanka and Vanuatu’ (details are available at: http://www.mcc.gov/Documents/PR_Eligible.pdf).

The criteria applied to arrive at this list have been described by Radelet (2004), which led him to predict a slightly different list of eligible countries. By comparison Benin, Cape Verde, Georgia, Mali, Mozambique and Vanuatu are in, and Bhutan and Vietnam are out. A possible reason for the discrepancy is that the comparators used to determine eligibility under the various criteria have margins of error and are capable of being interpreted in various ways. Indeed the World Bank Institute, on whose calculations the MCC relies heavily, expressed concern at the use of its figures in this way. As Kaufmann and Kraay (2002:1) point out, ‘simple “in-or-out” allocation rules risk misclassifying countries. These risks are not trivial: for one-third of the potentially MCA-eligible countries, there is at least a 25 per cent chance they will be mistakenly classified as below the median when they should be above, and vice versa. Rather than simply eliminating countries below the median, special scrutiny should be given to borderline cases’ (italics in original).
No doubt a form of political moderation was also applied. The case of Vietnam stands out, in that it scores poorly on the two Freedom House measurements for civil liberties and political rights, but is above the median on the other four scores, including the crucial corruption score. Clearly, the Bush Administration was not about to have a communist country as the main beneficiary of its new scheme. Looking at the MCA list, one is also rather tempted to ask ‘so what?’ Of the 16 eligible countries, only Ghana has a population more than 20m and only five other countries have a population of over 10m. Vanuatu boasts 200,000 people. So the MCA is hardly about to pass the impact test in terms of the key issue — global poverty.

Another caveat that needs to be expressed concerns the MCA’s capacity to deliver ODA. Bypassing USAID will create bureaucratic frictions. The established aid agency may not be fully cooperative, and the new agency will need to re-invent some wheels. Nevertheless, the MCC aims to be lean, responsive and flexible, relying on recipient country ownership of projects and outsourcing administration and oversight. It is certainly an experiment worth watching.

In terms of methodology, MCA is already having a significant impact. The quantification of eligibility criteria is an important new development that aid agencies throughout the world will study closely. It is not surprising that this phenomenon is recent, as it is only in recent times that comparators have achieved the range of sophistication and depth of issues to allow them to be so employed. Comparing nations by indicators other than blunt measures of population and the size of armed forces is a modern innovation, which first required the capacity to produce national accounts. Although international comparisons could be made by using GNP per capita figures, it was clear from the outset that these had limited utility. The first systematic multilateral set of purchasing power comparisons was that of the International Comparison Programme of the United Nations, which had its genesis in 1968 with the University of Pennsylvania taking a leading role (Heston et al., 2002). The number of countries covered rose from 16 for 1970, 34 for 1975, 60 for 1980, 65 for 1985, and 115 for 1996. The utility of the measurement was instantly apparent and opened the way for the crafting of many other comparators in the economic field and beyond.

The World Bank now publishes some 140 indicators quantifying the governance performance of countries, localities and institutions (World Bank, 2004). There has been a virtual explosion of datasets measuring quality of institutions, governance and corruption drawn from surveys, statistics and opinion polls. It is the existence of these indicators and the growing confidence in their accuracy that is preparing the way for a formulaic dispersion of ODA as a means of rewarding good performance. It has been only in very recent years that major donors like the EU and the US have drawn on such indicators as the means of applying both negative and positive conditionality. The methodologies are very likely to become ever more sophisticated in time.
Conclusion

The MCA has received some good press. Siegle, Weinstein and Halperin (2004) have lauded the use of qualifying criteria in the MCA process, and thus appear to accept the comparators as of sufficient quality and accuracy as a basis for aid disbursement decisions. Yet if the designers of some of these comparators argue that they contain a significant margin of error, surely it is difficult to place full confidence in decisions flowing from their use. It also means that absence of information will be tantamount to failing the test. East Timor did not qualify for MCA funding because insufficient data on it existed.

While the increasing use of comparators is inevitable, ultimately policy-makers should not abdicate their responsibilities to a set of measurements, no matter how ‘scientifically’ they were assembled. Policy-makers need a menu of options when dealing with development, and need to select from that menu a strategy appropriate to individual countries based on country specific expertise, much of which will be sourced in country. There may be times when negative conditionality is the best, or perhaps least worst, means of influencing the situation, as is the case in relation to Burma where, by giving Aung San Suu Kyi an effective veto over aid to that country, there is at least some local ownership of the development assistance issue.

In most cases the best option will be to employ a form of positive conditionality, but there can be no running away from the essentially political nature of the decision. Policy makers must make their own assessments of progress and reform in recipient countries. These assessments need to be tied to, and tested in, debate and deliberation in the democratic processes of both the donor and the recipient systems. It is only within these processes that the use of statistical comparators can serve a useful role as one guide to assessing performance in policies and competence in governance. Indeed it is likely that these comparators will become more useful over time, when they will be used not just to compare across countries but also to track change within countries. While most donors are unlikely to follow the MCA pattern and adopt comparators formally as the means of determining the direction of aid flows, it is highly likely that they will increasingly play this role informally within the debate over the direction and shape of aid.

Conditionality in ODA was part of the earliest processes of aid, and it is only natural that it should return to centre stage. When the rhetoric used by donors was about unconditional aid, this merely disguised the various forms of embedded and political conditionality that implicitly were being used. One of the best aspects of moving towards positive conditionality is the need for articulation of the requisite conditions. This could bring about greater transparency in the entire ODA process. With the conditions spelled out and, where appropriate, criteria for measurement set, developing countries will be in a more certain position, and perhaps better able to be assertive about ownership of the development process. Transparency should also have an impact on the donor. There will be pressure for any implicit political conditions to be made clear. If the MCA ruled out Vietnam...
because it failed the Freedom House measures, then these should have been spelled out from the outset as threshold qualifications. If Vietnam failed because it is a one party state, then this also needs to be stated. Because it is public money, ODA is already one of the most transparent and internationally monitored financial flows. The advent of positive conditionality will see that transparency applied beyond the disbursement of aid to its motivation.

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Wrestling with Outcomes: The New Zealand Experience

David Webber

Throughout the 1990s public finance officials from many countries, industrialised and developing, beat a path to the door of the New Zealand public sector to examine and assess its reforms in public management. Although there were numerous dimensions to these reforms (see Scott, 1996; Boston et al., 1996; and Schick, 1996) ‘output budgeting’ was undoubtedly one of the more interesting and innovative components. While it remains a core element in the structure and conduct of the budget process in 2004, an increasing focus on outcomes is significantly eroding the purity of this approach.

Since the mid-1990s at least, international experience and experimentation with new methods of government budgeting and expenditure management have also progressed, both towards and away from the New Zealand output-based approach. ‘Performance Budgeting’ — an increasingly broad term that now describes almost any approach or methodology that embodies a significant focus on results (including output budgeting) — is gaining increased acceptance. The basic argument for downplaying the role of outputs, while giving increased attention to outcomes, is well-summarised by Brumby and Robinson (2004:7):

A strong argument can be advanced for outcome-focused performance budgeting. Outcomes are the intended effects of government programs, whereas outputs — the goods or services delivered by government — are the means of achieving those outcomes. It can therefore be argued that outcomes are what really matters, and that to focus too much upon outputs in a performance budgeting system is to run the risk of focusing too little upon the effectiveness and quality of services. … Nevertheless, it can be argued that outputs must have a central role in a workable form of performance budgeting.

Recent developments in public sector budgeting in New Zealand fully reflect this search for a ‘more balanced’ focus. Indeed, considerable resources have been expended by both Treasury and the State Services Commission (SSC) to help departments achieve this (unspecified) balance and, in New Zealand’s case at least, to try to reconcile the serious methodological uncertainties and institutional ambivalence that accompanies it. There have been significant gains and losses along the way.

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The Problems with Outputs

The shift from an output to an outcomes focus in public expenditure management in New Zealand has occurred progressively over the last 4-5 years. It arose largely from two factors. The first was political. The 1999 elections brought in a Labour-led coalition government determined to roll back some of the policy reforms of the previous 15 years, including selected aspects of the ‘new public management’ model. However, from about 1997, the essentially political argument that Government should be more proactive in the economy was not entirely separated from a growing technocratic perception that output budgeting had failed to ensure that government departments gave sufficient attention to the results of their policy interventions. Although the subsequent shift was arguably more a bureaucratic initiative than a political one, it was an integral part of a wider response by central agencies to the (largely unspecified) demands of a new government for different and more effective approaches to public sector management.

The legislative basis for New Zealand’s output budgeting model was established primarily by the Public Finance Act 1989 (PFA). However, departmental experience with budgeting by outputs over the subsequent ten years had revealed a number of shortcomings. Perhaps the most obvious of these concerned the linkages established in the PFA between the accountability of public sector departments and agencies for outputs and ministerial responsibility for determining outcomes. Although some ministers took a conscientious approach to determining and monitoring their policy outcomes, this separation of responsibilities became a key factor in the unsatisfactory linkages between outputs and the intended impacts of spending programs. It was accompanied by a growing consensus in the domestic public management research literature that ‘a key weakness in the current regime is the lack of information on the effectiveness of the public sector’ (Petrie and Webber, 2001:para 119).

One initiative to address this problem, ‘Key Result Areas’, had been largely abandoned by the late 1990s, despite the fact it had succeeded in some respects in drawing departments’ attention to the importance of the relationship between the design of their interventions and the expected, or intended, policy impacts.

Lack of departmental performance and attention to the impacts of public policies were not the only perceived shortcomings of the output-based approach. Problems also arose from the legislative requirement for departmental votes to be comprised of ‘Output Classes’ (defined effectively as groups of ‘similar outputs’). In practice, similarity of outputs has not provided a meaningful basis for organising departmental expenditure operations, much less for effective parliamentary scrutiny and debate of expenditures. On this latter point, there is some evidence that these somewhat obscure categories of expenditure contributed to waning ministerial understanding of, and interest in, the detailed spending activities of their departments (Economics and Strategy Group, 2003).

As a result, the definition and composition of Output Classes across the public sector have shifted in recent years towards more management-related criteria. However, even within votes, few output classes are now based on
consistent criteria and only some provide a meaningful indication to Parliament or the public of the expenditure purpose or intended impact.

At the operational level, weaknesses in the output model also contributed to a gradual devaluation of its status as a budgeting innovation, in New Zealand and internationally. Examples included the difficulty in reaching meaningful and measurable definitions of ‘outputs’ and ‘output performance’ in significant areas of departmental administration, such as policy advice or ministerial servicing. This was accompanied by increasing frustration in some departments with the resource demands and perceived inconsistencies in the conduct of ‘output pricing’ reviews — that is, formal procedures for establishing and reviewing the ‘prices’ to be used by departments for costing (predominantly non-market priced) outputs.

Notwithstanding these concerns, there is broad agreement that the overall efficiency of government improved substantially as a result of the public management reforms and that the strong focus on requiring departments to define and cost their outputs had been a significant contributor to the gains. However, the effects of a greater international focus on performance issues, combined with arguments for greater attention to outcomes by well-qualified commentators and advisers, such as Boston et al (1999), Controller and Auditor-General (1999), and Schick (1996) were formidable. The SSC too was pressing for the adoption by departments of a more ‘strategic management’ approach. By 2001, it was clear that some modifications to the output focus were both desirable and inevitable.

The ‘Review of the Centre’

Many of the subsequent adjustments to the New Zealand model of public management in the past 3-4 years have their origins in the analysis and recommendations of the ‘Review of the Centre’ (RoC) — in essence a review by a committee of officials from central agencies with input from a small number of external advisers (SSC, 2001). Although this committee was established to review the roles and activities of the central agencies — hence the name — its focus shifted to much broader public management issues. In particular, its focus was on various shortcomings that had been identified in the public management model established by the reforms of the late 1980s. The RoC grouped these perceived problems into three main major categories: a lack of integration in the delivery of government services; associated fragmentation and lack of alignment within and between sector departments and agencies; and weaknesses in building and sustaining institutional capabilities and organisational culture.

The main thrust of the RoC’s recommendations for modifying the budgeting and expenditure management process involved adding-on a much stronger results (outcomes) focus to the existing output-based model. It noted that the public management reforms of the late 1980s had ‘hard-wired in an output-based management system’ RoC (2001). The aim, therefore, was to soften this output-based model rather than replace it with a new or different approach. However, it also argued that departments be required to build procedures and documents into their annual planning activities that would strengthen their internal strategic
planning process. Importantly, it noted that these strategies should be aligned with outcomes to be identified by departments, in consultation with their ministers.

The RoC analysed the above problems with reference to recent innovations from international managerial journals and literature, but with little or no theoretical underpinning in public financial management. At no stage did the RoC analyse the strengths and weaknesses of the output model itself, nor describe how the proposed changes would fit within a coherent new expenditure framework. This incremental approach was effectively endorsed by the Minister of Finance in 2003 who stated that the legislation underpinning the output-based model did not require major amendment: ‘Experience shows that the fundamentals of the two Acts (the *State Sector Act 1988* and the PFA 1989) are sound’ (Cullen, 2003).

The resultant RoC recommendations were arguably pragmatic, but noticeably lacked effective reconciliation of output and outcome concepts. The expenditure management process was thus modified with the addition of a series of planning and reporting requirements to the original output-based model, without a clear explanation of how expected improvements in policy outcomes would occur.

**Managing for Outcomes**

Since 2001, departments have received instructions and support for implementation of the RoC’s recommendations through an intensive series of workshops and guidance materials under the ‘Managing for Outcomes’ (MfO) initiative. This has been a combined undertaking of the central agencies, principally The Treasury and the SSC, which did much of the work to guide and support departments in the uptake of this approach. Introduction of the MfO initiative has required departments to produce annual *Statements of Intent* (SOI) that emphasise a ‘strategic outcomes framework’. An explicit consequence of this focus has been less reliance on the previous, narrower, output-based planning. The more explicit outcomes focus in planning is also to be reflected and reinforced by parallel adjustments in official departmental documents relating to *ex post* (performance) reporting. Proposed amendments to the PFA (currently before Parliament) will effectively cement these modifications into legislation.

Recent evaluation work on the uptake of MfO concepts and tools suggests that good progress has been made in some areas, especially in developing SOIs (see, for example Economics and Strategy Group, 2003). However, the absence of a clear and fully articulated model in which output and outcome concepts are effectively integrated in the budgeting and expenditure management process has generated particular difficulties for senior managers in many departments. In terms of Figure 1, it has presented departments with considerable challenges in linking the rationale for their spending operations with both appropriations (that is, relevance) and with impact assessment. Not surprisingly, the requirements to develop a meaningful ‘intervention logic’ and an effective structure for

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1 A number of papers and guidance materials relating to this initiative are available at [www.ssc.govt.nz/managing_for_outcomes](http://www.ssc.govt.nz/managing_for_outcomes).
‘performance measurement’ have clearly emerged for all departments as the most difficult aspects of implementing the MfO initiative. The MfO model of expenditure management provides neither an inherent process, nor clear guidance, for making these critical linkages, but requires only that they should be made.\(^2\)

Experience so far has generated a range of departmental-specific responses and practices that vary significantly in both content and merit (ibid). The development of a set of performance measures to provide an accurate assessment of progress or impact, especially where the specified outcomes are broad or ambitious, has been a common difficulty. It is no surprise that, as a result, some chief executives have pointed to the SSA 1988 to remind central agency officials that they (and their departments) are not accountable for achieving outcomes.

**Figure 1: Linking the Basic Components of the Expenditure Process**

<table>
<thead>
<tr>
<th>Appropriation</th>
<th>Spending Program/Activity</th>
<th>Impacts</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>__ Intervention Logic ___</td>
<td>___ Performance Measurement ___</td>
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</table>

While many of the former requirements on output planning, specification and reporting remain, the precise roles and importance of both outputs and ‘output classes’ are much less clear, and fit less comfortably within this new framework. Currently proposed amendments to the PFA are, in effect, aimed at keeping and reconciling aspects of both models but fail to provide either conceptual or practical clarity on this issue. This approach was described by a central agency official as ‘not wanting to throw the baby out with the bathwater’.

The lack of a formal and coherent framework for expenditure management may also have increased the difficulty in integrating other critical facets of improved public management. For example, a clear framework could have provided a recent review of evaluation activities within the public sector (SSC, 2003) with a better starting point for determining the likely contribution (where and in what form) of evaluations to the assessment and development of policy objectives and performance. Recommendations from that review (which supported the utility of evaluation capabilities, but left individual departments to determine the role, structures and methods) reflected, in part, the uncertainty surrounding the integration of output and outcome methodologies, including where performance evaluation could best contribute to policy development.

Finally, recent indications that some departments may also be considering re-aligning organisational structures on the basis of outcomes is a particular cause for concern. At no stage yet have any departments formulated a set of practical and

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\(^2\) Early in the MfO development process there was an attempt to provide departments with a business-planning model for a more effective planning process. However, this was abandoned when the initial model failed to gain acceptance among the pilot agencies.
achievable intended outcomes that could be said to provide a clear and consistent basis for expenditure management, much less functional alignment.

Whether the difficulties facing departments in adopting this new hybrid model of expenditure management are just teething problems or reflect deeper incompatibilities in design is not yet fully clear. Nevertheless, it can be argued that practical application of the new outcome-focused structure has proved difficult for central agencies to define and explain, and is proving difficult, and onerous, for departments to implement effectively.

**International Experience with Outcomes-Based Budgeting**

The New Zealand public sector has not been alone in recent years in struggling to achieve an effective application of outcome concepts. The Finance Committee of the Scottish Parliament recently commissioned an international survey of outcome budgeting experience to help to guide it in the possible introduction of these concepts (Flynn, 2001). The survey found sufficient support for the introduction of outcome statements in the design and presentation of appropriations, but cautioned the Finance Committee against having high expectations of what outcome setting could reliably add to the quality of resource allocation decisions.

For New Zealand, however, the key issue has involved how best to overlay an outcomes focus on an output budgeting model. Brumby and Robinson (2004:8) cite the British Public Service Agreement (PSA) system in this context:

> When the system started off in 1998, most of the PSA targets were output targets. In the two subsequent rounds of PSA target setting, there has been a progressive and deliberate re-orientation towards outcomes, so that today most PSA targets are outcome rather than output targets. Nevertheless, outputs have not been forgotten. Service Delivery Agreements have been introduced at a more operational level, and these set targets for outputs which are intended to mesh together with the top-level PSA outcome targets.

The fact that the United Kingdom started this process two or three years ahead of New Zealand may be encouraging. Although the authors do not comment on the success of the ‘meshing’ process so far, anecdotal reports suggest that a slightly messy, but perhaps more structured relationship has developed in some areas between the two sets of concepts and measures — albeit through a mostly *ad hoc*, experiential process. A similar process is now clearly occurring in New Zealand, but also without conclusive results.

These conservative assessments underline the fact that most countries engaged in outcome specification have experienced significant challenges. These include maintaining consistency in the definition of outcomes (in terms of the level at which outcome objectives are set), maintaining the feasibility and practicality of outcome targets (in the face of political pressure to aim higher), and
Wrestling with Outcomes: The New Zealand Experience

identifying and maintaining well-specified outcome targets for long enough for meaningful performance measurement and policy assessment to occur.

Not surprisingly, the definition of an outcome — as opposed to other potential policy impacts — has tended to be wide and variable within and across departments and in some cases set at levels well outside the feasible reach, or direct policy influence, of the department. Within both the public and private sectors in New Zealand the identification of an ‘outcomes focus’ has already been coined as a trendy (but often insubstantial) indicator of the relevance of policy or research. There is also slow, but increasing, realisation in some parts of the public sector (for example, with regard to the targeting of welfare payments) that this year’s policy problems are not infrequently last year’s policy outcomes.

Policies often do not achieve what politicians or bureaucrats expected and the expenditure management framework needs to ensure that policy design can respond quickly, and appropriately, when needed. Too much emphasis on outcomes makes this more difficult if the government appears to be ‘giving up’ on a particular outcome statement. It is therefore critical that outcomes, or results, are defined at a level on which public policy may have a measurable impact.

In addition, significant insights from the international managerial literature and private sector management practices (especially on strategic management) have also been increasingly overlaid on the task of managing public finances. While each of these concepts and innovations may have added interest and richness to the subject, for most New Zealand Government departments at least, they have also added greater expectations, complexity and compliance demands.

It therefore seems reasonable to ask whether the public sector is still on track to achieving new and improved levels of effectiveness in public spending? Is there a risk that in pursuing an almost ‘continuous improvement’ approach (cycles of reform in effect) that the budgetary system that is developing in New Zealand lacks overall coherence, or even a basic managerial orientation? Does the current approach still embrace all that is fundamental to good budget management?

The Fundamental Elements

All budgetary and expenditure management systems — whether they are labelled (or have origins in) ‘Program Budgeting’, ‘Performance Budgeting’ or ‘Outcome Budgeting’ to name a few — are concerned with ensuring that public spending agencies use public funds effectively (that is, deliver value for money in implementing government policy). While economists may describe and assess this objective in terms of ‘aggregate, allocative, and technical efficiency’, most public sector employees simply see them in terms of ‘appropriation’, ‘spending operations’ (often ‘service delivery’), and ‘performance measurement’. However, it is often less well recognised that the efficacy of the system is determined by the quality of the interactions, or managerial linkages, between these components.

Different budgeting methodologies can and do give different emphasis to the various components, or connections, within this structure. The relative simplicity of the above objective for public expenditure understates the real difficulties in
obtaining meaningful assurances of quality and integrity. In practice, the public relies heavily on various institutions, including Parliament as well as private commentators and non-government agencies, to monitor and where possible ensure the quality and effectiveness of the spending decisions and actions of the government. However, many of these institutions and observers have a tendency to focus on specific stages, or components of the financial management process. The ultimate value and quality of their analysis and reporting therefore depends on a management process that is not only clearly defined, but also effectively linked.

**Connecting Management Decisions**

As Figure 1 indicates, the fundamental elements of a public expenditure system are not complex. The challenges lie in linking the various components effectively. For government departments, uptake of the MfO initiative has imposed a strong (though not unreasonable) demand to rethink, formulate and articulate their ‘intervention logic’, and a supporting ‘performance measurement framework’, to a degree that was not required before. The eventual success of this evolving model of budget management will depend substantially on departments acquiring, or developing over time, the skills and capability to do this, including especially achieving an effective integration of output and outcomes concepts.

Another factor evident during the piloting stage is that the technical expertise required to develop a sophisticated and effective strategic and performance measurement framework for guiding management decisions requires skills that are not only in short supply in the wider public sector, but are often limited to even one or two individuals within the larger departments. Moreover, the operational environment and budget management needs of departments vary significantly and general guidance material cannot make the outcomes structure a readily applicable tool. Faced with this, much of the work required for outcomes specification and the associated documentation has been assigned to small groups of policy and strategy analysts within departments whose task it is to make the framework and performance measures ‘fit’ with departmental policies and operations.

There is a clear risk that ceding this responsibility to a very small number of specialists, or worse to out-sourced consulting expertise as has also occurred, will distance the process further from the day-to-day managerial and operational teams. A sound framework for managing public expenditures can be achieved only when it is fully understood by, and is effectively in the hands of, departmental budget managers. Many larger departments in particular must be constantly focused on the management and delivery of core programs and services that meet relatively simple, but invariably high, public expectations. While they can identify, assess and report back on the consequences of their activities, it is much more difficult to develop effective policies from objectives and statements based on longer-term outcomes (even assuming that modestly accurate and timely performance data are available). The Scottish study referred to above includes a powerful conclusion, from Swedish experience, that outcome data alone do not imply (or engender) a capacity to use those data to design more effective interventions.
A further complication with practical application of the outcomes focus arises from the fact that a substantial majority of the spending activities of departments are on-going (baseline) policies and activities. New policies that provide an opportunity to focus first on outcomes (before detailed operations and organisational responsibilities are determined) occur infrequently, or at the margin of on-going departmental expenditure programs. It is no surprise that organisations which appear to have adopted the outcomes model most readily (for example, the Department of Corrections) are those whose mandate implies a relatively tightly-constrained ‘outcomes set’, for example, secure confinement and reduced re-offending rates for prison inmates. Similarly, departments such as the Ministry of Fisheries appear able to apply an ‘outcomes’ focus more readily provided that this is constrained to quite specific resource management and monitoring functions.

In practice, the departments perceived to be more successful in applying the outcomes-based approach to date are those which are focusing on more narrowly defined targets — better described as results. Take away this more narrow focus (for example, by introducing broader industry development or improved societal welfare goals) and the task of specifying an outcomes-focussed intervention logic, with relevant performance measures, becomes problematic. So it is perhaps not surprising that the departments whose predominant output is ministerial ‘policy advice’, of which there are several in New Zealand, have generally had the greatest difficulty in developing a meaningful outcomes-based strategy and performance measurement framework (Economics and Strategy Group, 2003).

**Beyond Outputs and Outcomes**

The Managing for Outcomes initiative has undoubtedly succeeded in nudging most departments towards a more performance-oriented view of their activities. It has not, however, prompted this development in a way that guarantees an improvement in the quality and impact of government interventions. On the contrary, most departments have struggled to develop effective forms or expressions of intervention logic and performance measurement within the outcomes model. At the same time, some of the sharper accountability features of the previous output-based public management regime have been eroded.

Application of the outcomes-oriented approach has found many departments, especially those with a wider and more complex mandate, with insufficient skills or tools for this transition. An increased focus on results is desirable, but this needs to be implemented in ways which involve retaining the strengths of the output budgeting model. Successful application of the results focus also requires a methodology that better enables departments to achieve effective integration of policy design, operations and service delivery and impact assessment.

Figure 2 attempts a more detailed exposition of the nature and composition of the budgeting and expenditure management process, including a more integrated expression of the core relationships. Moreover, it links the contribution from each of these functions to a range of public management objectives invariably present in most well developed public administrations. It demonstrates that operational
activities sit at the centre of departmental management and resource allocation decisions and that the impacts of these decisions may be measured and assessed in varying ways, and at varying distances, from the program delivery function.

Outcomes are shown as being clearly at the end of this process. For this reason, they may often be the most difficult point from which to work back to improved policy and operational decisions, much less to an expression of the department’s intervention logic and its funding (that is, appropriation) criteria. Furthermore, Figure 2 indicates the linkages between the essential components of the expenditure management process in a way that meets parallel and specific demands for ‘relevance’, ‘efficiency’, ‘effectiveness’ and ‘sustainability’.

Figure 2: The Expenditure Management Process

Program Design and Delivery: The Essence of Intervention

The difficult task of determining intervention logic is best undertaken in the course of designing and developing a department’s operational programs and activities. This is the point at which the broad policy objectives implied by a government’s appropriation decisions are converted into practical operations and services. It is at this point that a department must make its policy objectives explicit and link them to specific spending decisions that will generate quantifiable outputs. Determining the department’s intervention logic cannot be separated

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3 Figure 2 is adapted from an idea in a European Community (2000) working paper on designing evaluations. The power to design public policy evaluation based on the dotted relationships presented across the public expenditure management process is an important feature of this Figure, but is not fully elaborated in this paper.
from the process of determining what operational activities those interventions may require, including their respective chances of success.

This approach of starting from the integration of policy objectives and the design of programs is arguably much more consistent with organisational structures and the assignment of managerial and budget responsibilities than an outcomes-first approach. In particular, it avoids one of the problems with an outcomes-based approach that managers may become isolated from the planning process and therefore unable to closely, or usefully, relate their activities to specific outcome targets.\(^4\) It also helps to avoid the problems that may arise from an almost exclusive focus on outputs where managers and operational staff fail to identify with a comparatively sterile description of purpose and incomplete, or unchallenging, measures of performance and accountability.

Once the core rationale for the department’s intervention has been established through this linkage of policy objectives and program operations, it is a relatively simple process to work outwards (in both directions) towards a preferred structure of appropriation and performance measurement needs, without losing any of the benefits of either the outputs or outcomes-based concepts.

**Appropriations**

The organising principle for budget appropriation in New Zealand has traditionally been institutional. It is only by clearly assigning public monies to specific organisations, within which managerial and financial accountabilities are clearly identified, that full accountability can be maintained. Attempts elsewhere to appropriate by outcome or similar organising principles have almost always given way to a need for improved transparency and accountability through at least de facto assignment to specific institutions. The propensity to appropriate budget funds on the basis of ‘joint’ or ‘cross-sectoral’ outcomes should be resisted for similar reasons. Where common outcomes are identified, they can be pursued much more effectively, and with greater transparency and accountability, through coordinated departmental management and operational or service delivery, mechanisms.

Effective parliamentary scrutiny and control of expenditures requires that aggregate appropriations in most cases need to be broken down into smaller categories of expenditure. New Zealand’s current sub-appropriations, or Output Classes, are no longer effective within the present expenditure management framework. (In fact, definitional problems have always prevented them from becoming a satisfactory mechanism for sub-grouping an appropriation.) These Output Classes need to be replaced in favour of appropriations that are broken down on a functional, programmatic basis — that is, programs with broadly related expenditure objectives, or common goals that are understandable to, and reviewable by, the Parliament. Such programs may, of course, still be able to be

\(^4\) It is worth noting in this respect that one or two departments that have made considerable efforts to involve line managers and operational staff in the initial outcomes planning process have commented that they hope that such extensive consultation will not be necessary in future years.
aligned with a common specific outcome, or sub-set of outcomes, within the sector.

*Outputs*

Figure 2 also reveals a clear and logical hierarchy of performance measures that flow upwards from outputs to results and finally outcomes. It shows that outputs have a special and important role within any performance measurement framework by enabling departments to express their policy decisions and program design in terms of practical and transparent purchases, or provision, of goods and services. New Zealand’s experience with outputs argues strongly for their retention as an integral part of the expenditure management framework. However, this role should be (a) as a key *accountability* device (‘What were public funds actually spent on?’) and, (b) as an effective basis for establishing and monitoring *efficiency* issues. For some departments, however, not all activities can be usefully expressed or monitored in output terms.

*Results*

Policy and program interventions are, or should be, designed to achieve a clear and measurable set of results that sit between outputs and outcomes. Results should be directly linked to program objectives as the direct consequences or impacts of the expenditure. They differ markedly from outcomes in two main respects: their achievement is totally or very substantially the result of the policy or program and this impact or improvement is evident and measurable within a policy-relevant period. As Figure 2 indicates, this is the only level at which it is feasible and meaningful to assess the *effectiveness* of interventions. If relevant and measurable results cannot be articulated, then the policy or program design needs to be revisited. As with outputs, the measurement of results should for most programs be limited to a small number (2-5) of critical indicators.

*Outcomes*

The budgeting and expenditure management framework proposed in this paper includes a continuing, albeit adjusted, role for outcomes. Their most important function is to indicate the *sustainability* of the range of government expenditure policies embodied in current appropriations. The sustainability objective is best measured by the degree to which government policies collectively — that is, taking into account the interventions of all public agencies within the sector, plus the incentives or controls applied to private behaviour especially through regulation and enforcement — have a positive, or negative, longer-term impact on societal outcomes.

Monitoring of these outcomes, most likely at the sectoral level for most departments, should therefore enable departments to advise the government on the degree to which the total sum of their policies and operations may be contributing to positive change. Conversely, measurement of outcomes rarely provides a
particularly useful indicator of either the efficiency or effectiveness of individual agencies or expenditure programs and ought not to be used for this purpose.

This configuration of the outcomes focus implies a different, but no lesser, role from that currently assigned to them in the MfO initiative. Indeed, some departments with comparatively limited operational functions — such as policy ministries in Health or Research, Science & Technology — are now (after some initial missteps) recognising the need to assign outcomes to this broader (that is, sectoral) performance measurement role. Other ministries need to follow this example, ensuring in the process that outcomes are expressed as sector, not departmental, goals. This implies that outcomes — and outcomes measurement — should have only a background role in assessing the effectiveness of policies and therefore in the accountability framework of the department.

Evaluation

Finally, it should be evident that this framework makes it easier to assign clear objectives and an explicit focus for the evaluation of public expenditures. The performance measurement hierarchy in Figure 2 not only identifies the various types of evaluation — any one or more of which may be appropriate for different purposes — but links these concerns to the corresponding form and level of objectives. From here, it should also be possible to establish more clearly the appropriate boundaries of institutional performance and accountability.

Conclusion

An output-based budgeting framework brought much-needed specificity and accountability to the spending operations of the New Zealand public sector. However, it was perceived as failing to generate sufficient attention to, or improvement in, the impacts of government policies. Requirements for an increased focus on outcomes have been directed at these problems, but have created many difficult challenges for most departments. The new Managing for Outcomes approach risks eroding clear understanding of the determinants of policy effectiveness and may have already removed some of the sharp edges from organisational accountability. These developments have potentially serious implications for the quality and integrity of public spending. Sound management of public finances should be pursued by moving beyond outputs and outcomes to a clearly articulated and effectively integrated expenditure management framework. This will be one that puts policy design and program delivery back at the core of the expenditure management process and binds them to a set of clear, modest and achievable policy objectives and intended results.

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Extraordinary Circumstances and Regulatory Pricing

Joshua Gans and Stephen King

Extraordinary events cause significant supply disruptions for major utility industries. When the relevant suppliers are regulated firms, standard market responses to extraordinary events, such as individual customer contracts with an allocation of liability, are unavailable. Both the existence of regulation and political necessity mean that such events often involve a costly response by government, the regulated firms or the public. State-based regulators around Australia are grappling with the problem of how to deal with these costly responses in on-going utility regulation. In this paper, we provide a framework for analysing regulatory responses to extraordinary circumstances. We note that dealing with the risk of extraordinary events is a standard insurance problem. The regulatory issue involves incorporating relevant insurance principles into the on-going system of regulation. This is likely to involve a balance of mandated precautionary activity combined with government and public liability, together with risk-bearing and self-insurance by the regulated firm. This balance determines the liability for expenses and compensation arising from an extraordinary event. It also determines both the pre-event and post-event regulatory procedures that will govern the utility. In particular, it is impossible to separate the pre-event regulatory regime and the post-event liability for costs.

Background

Infrastructure regulators are currently investigating the establishment of pricing principles to cover investments made either under extraordinary circumstances or in response to an extraordinary circumstance (for example, the Queensland Competition Authority and the Essential Services Commission in Victoria). These regulators set the prices and vet the costs for regulated firms in gas, electricity, water and other infrastructure industries. The key issue they face is how to use their regulatory powers to allocate the costs of unexpected investments that are needed to address an extraordinary circumstance. While the precise definition of an extraordinary circumstance is still to be established, there is some confidence that the severe drought conditions affecting Gladstone’s water supply, the electricity outage in Auckland, the Longford gas disaster in Victoria and the Sydney water crisis, all fall into any reasonable definition.

In this paper, we provide an overview of the pricing instruments and trade-offs associated with extraordinary circumstances and regulatory pricing. We

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consider both the definition of an extraordinary circumstance and the underlying regulatory economic issues raised by the possibility of such extraordinary circumstances. In particular, we note that the way a regulator deals with investments made in response to an extraordinary circumstance is critically dependent on the regulatory approach to risky events established prior to any extraordinary circumstance occurring. In other words, dealing with extraordinary circumstances involves a regulatory role and requires consistency of regulatory approach both before and after an extraordinary circumstance. In this sense, it is impossible to consider the appropriate regulatory response to be taken after an extraordinary circumstance unless the regulatory approach to risk before such a circumstance is fully articulated.

This paper proceeds as follows. We begin by considering the definition of an extraordinary circumstance. Then we consider the relevant regulatory approaches that can be adopted to risk before an extraordinary circumstance arises and in preparation for such a circumstance. We also discuss how these ex ante regulatory alternatives feed into compensation for extraordinary circumstances.

Definition of ‘Extraordinary Circumstance’

Regulators use the term ‘extraordinary circumstance’ (or EC) to characterise events that have two specific characteristics. First, regulators define an EC as an event that occurs with low probability. Second, to be an EC, the relevant event must involve some major disruption to supply that can be made less likely by reduced consumption and increased investment in capacity. Regulators control either the ability of a regulated infrastructure firm to invest or the ability of that firm to recover its investment expenses, so this second characteristic means that there is potential for a regulatory response to the EC.

Both of these characteristics involve a continuum. The probability of an event occurring can range between zero and unity. Consequently, any definition of an extraordinary circumstance that captures both of these characteristics will either rely on arbitrary boundaries on both the probability and degree of disruption, or will have a significant ‘grey area’ for dispute.

At its simplest, as used by regulators, an EC could be defined as a highly unlikely event involving a prolonged and widespread loss of supply. However, such a definition would be inadequate. Neither the probability of a particular supply-side event, nor its intensity, is outside the control of the infrastructure firm and the regulatory authority. Further, such a definition would capture a wide range of events in industries that require no government intervention whatsoever.

There are many industries where a major disruption to supply is possible. For example, in 2003 the Australian car industry was brought to a standstill due to an industrial dispute that prevented a key component being delivered to automotive plants. This was a major disruption to supply in that industry. However, it did not lead to a regulatory response because the supply shock was an internal matter to the relevant supplier, the workers and the car plants that purchased the component. From a regulatory perspective, the supply shock did not require intervention.
Thus, if we are to consider the definition of an EC for a regulated infrastructure industry, we cannot simply refer to it as a significant supply shock without considering why the supply shock calls for a government regulatory response.

From an economic perspective, there are *prima facie* efficiency grounds for government intervention in a supply shock that gives rise to large effects that are not internalised by the relevant market participants. If a supply shock leads to a relevant market response without external costs, then there is little if any need for government regulation. For a regulated infrastructure provider, however, such a market response to an external shock will be muted at best. The contracts between regulated firms and their customers are usually controlled by the regulator. The regulator vets investment both before and after an EC and any responses to an EC by a regulated firm usually require regulatory approval. Customers have a limited ability to seek compensation for the costs of an EC through the legal system. Politically it is often impossible for governments to ‘stand by’ and let the market work out the consequences. As a result, an EC will often lead to external costs that cannot be internalized by the market. Therefore, when considering the definition of an EC in a regulated industry the relevant dimension for analysis is not the size of the supply disruption *per se*, but rather the size of the external costs to the community of the supply disruption. In other words, when considering an EC, we need to focus on the size of the external social costs of the supply shock.

The second problem with a definition that focuses on small probability events involving large supply shocks is the failure to recognise the roles of the firms and regulators in determining the probability of specific events. There is clearly a wide range of potential factors that creates supply risk in any industry. Supply risk could relate to acts outside the relevant firm’s control (for example, acts of God, acts of terrorism) or to factors such as maintenance and investment in capacity that are directly controlled by the firm. In many circumstances, an extraordinary event will involve both controllable and uncontrollable risk. For example, in the case of the Gladstone Area Water Board, drought resulted in a severe reduction in the local supply of water, and the potential for the area to literally run out of water. Clearly the extraordinary drought was beyond the Water Board’s control. But the potential supply disruption created by the drought was not beyond control. The Board could have lowered the risk of an extraordinary drought creating supply disruption by building larger water storage facilities before any drought occurred. In other words, while the probability of extraordinary drought was outside its control, the Board had control over the probability of an extraordinary drought causing a significant supply disruption.

Similarly, the regulator’s actions prior to the drought affected the probability of a significant supply disruption. The regulator (or another government agency) could have required the building of extra storage capacity. It chose not to do so. While this could be an economically sensible decision, it highlights that the probability of supply disruption is not exogenous to the regulatory process.

The relationship between the probability of supply disruption and regulation highlights two factors. First, to the degree that supply disruption is outside the control of the relevant parties, regulation dealing with the disruption will resemble
insurance. If there is exogenous risk of supply disruption then some party must bear that risk. This may be the community serviced by the regulated firm, the regulated firm itself, the broader community — either State-wide or Australia-wide — or a combination of all three groups. Whichever party bears that risk, will need to be compensated for it. The principles of good insurance suggest that the risk should be borne by the parties who: (a) are the least risk averse in the sense that they place the lowest cost on bearing risk; and (b) are in the best position to pool risk in order to lower the total variance of risk faced. At the same time, these principles will need to fit in with practical regulatory constraints.

Second, to the degree that supply disruption and the intensity of any disruption depend on the individual firm, the regulator has a role in risk regulation. The regulator needs to establish regulatory principles that lead the regulated firm to take appropriate care in order to reduce the probability of a severe supply disruption that creates significant external community costs. This does not mean that risk should be reduced to zero. Such risk minimisation will generally be prohibitively expensive and the costs will outweigh any benefits. Rather, the regulator needs to determine: (a) the optimal level of risk for society; and (b) how best to lead the regulated industry to have that desired level of risk.

In summary, a naive definition of an extraordinary circumstance as a major supply disruption that occurs with a low probability is unsatisfactory because it does not address the key social costs and because it ignores the endogenous nature of the probability of a supply event. For this reason it is better to define an EC in terms of the magnitude of the external cost imposed on the community through a supply disruption for a regulated firm. Such a definition focuses clearly on the issue of importance for regulatory intervention and draws attention to the necessity of isolating the regulatory reasons why the social costs are not internalized.

**The Economics of Risk Regulation**

The economic principles underlying risk regulation need to be considered before looking at the issues that regulators need to address when considering the pricing principles for EC related investments by regulated firms. Why is risk a matter for concern in regulated infrastructure industries? How can regulators deal with risk regulation *ex ante* before there is an EC? How does the regulatory response after an EC tie into the general framework of regulatory risk adopted by the regulator?

*The basic problem*

The basic concern is that a regulated firm in an infrastructure industry may not provide a socially optimal level of supply security. More particularly interruptions may occur too frequently and at too high a cost to the general community.

The socially optimal level of supply security is unlikely to be a standard of perfect reliability where there are no interruptions. While reducing the probability of an interruption to zero would benefit the community, the cost of doing so would often be prohibitively high. These costs are associated with actions that agents in
the economy can take to increase the security of supply. Although these actions may be conveniently labelled, precaution, they comprise investments in redundancy, safety protocols, substitute supply sources, alert-awareness and the like. Each of these actions is costly. To evaluate whether they are worthwhile, the cost of these activities must be compared with the benefits they generate.

A competitive firm in a private market will often face incentives to invest in a socially appropriate level of precaution, particularly if consumers can hold that firm liable for the costs of any supply disruption. To the extent that different consumers require different levels of security, this can be written into supplier-customer contracts. While standard issues such as asymmetric information and moral hazard may limit the ability of competitive markets to achieve optimal solutions, market outcomes will often be adequate and require no further intervention.

Such a market-based approach cannot be relied on for large infrastructure firms subject to strong regulation. First, the regulator usually sets the prices and the relevant service standards. There is no scope for standard market solutions to achieve an optimal level of precaution. Second, regulators usually vet investments and other activities such as maintenance to ensure that a firm is not artificially ‘gaming’ the regulatory system. Thus, even if a regulated firm wishes to alter precautionary activities, it would need to satisfy the regulator that this is legitimate. Asymmetric information between the regulated firm and the regulator may make this vetting process difficult.

Third, to the extent that the infrastructure involves networks and security is part of network integrity, then it is difficult for a consumer in a locality to have secure supply while another does not. Thus, any private market solution is likely to fail because customers purchasing higher supply security are likely to create a positive benefit for other customers, who may not pay for the improved security.

Finally, an EC often generates large costs that, politically, cannot be ignored. If a major town runs out of water or loses power, it is politically impossible for regulators not to respond even if they believe adequate precaution was taken. Further, advising consumers to ‘sue the regulated firm’ is unlikely to be considered an appropriate response.

The issues

Given that the privately provided level of precaution by a regulated infrastructure provider is likely to differ from the socially optimal level, there are three key regulatory issues to be resolved. First, should the government specify a set of precautionary investments and activities (that is, mandate standards) or should it let the regulated firm decide these for itself? This is a question of the allocation of decision authority with regard to precaution. Second, how should the regulated firm be compensated for its precautionary activities, whether mandated or not? This is a question of how precautionary expenses and risks are built into regulated prices. Third, if an extraordinary event occurs and there is a supply shock that requires significant rapid investment or other mitigation costs, who should bear
the costs? This question recognises that optimal risk regulation will not eliminate risk of significant supply disruption, and the regulator needs to establish well defined rules in advance to deal with such a disruption if and when it occurs. We consider each of these issues in turn.

**Allocation of decision authority**

Consider a situation where, left to itself, the level of supply risk in a regulated infrastructure industry is too high from a social perspective. Regulators have an incentive to raise the level of precaution undertaken by firms. How might they approach the regulation of supply risk to ensure appropriate precaution is taken?

One approach would be that of *mandated standards*. In this situation, the government assesses the precautionary actions, procedures and investments an infrastructure provider should make and requires the regulated firm to carry out them out. Alternatively, the government specifies the *penalties* that would be imposed on a regulated infrastructure provider in the event of a disruption to supply. It would then be up to the provider to manage the risks. Thus, there are two broad classes of regulatory instruments for managing supply risk:

- **On-going regulation.** Instruments designed to monitor (or audit) the current (or historic) levels of precaution taken by regulated infrastructure owners and provide incentives or performance sanctions to ensure a socially optimal level of precaution.
- **Liability rules.** Operation of these instruments is triggered by an actual interruption. Each specifies a set of sanctions and compensations that must be paid by the regulated infrastructure firm if an interruption occurs.

In what follows we will review instruments of each type in turn. It will be argued that a reliance on one type alone will generally be inadequate for the optimal regulation. Hence, it is likely that a combination of on-going regulation and liability will be the appropriate policy.

**On-going regulation**

On-going regulation involves more active government involvement in the actions of infrastructure firms. The objective of on-going regulation is to reduce the likelihood of a major interruption through the development and review of operating standards. Possible instruments include:

- **Periodic audits:** the government periodically holds inquiries into the level of precautionary actions undertaken by infrastructure providers.
- **Standards:** standards for precautionary actions are taken and monitoring used to ensure those standards are being met on an on-going basis.
- **Incentive regulation:** rewards and sanctions are instituted on a recurring basis for failure or otherwise to undertake precautionary actions.
On-going regulation has the potential to generate a socially optimal level of supply security. However, it places incentives directly on precautionary actions rather than indirectly on the observed consequences of those actions. As such, the information requirements for the regulator are more onerous. The regulator needs to have some way of assessing the optimality of desired levels of precaution as well as monitoring whether those actions have been taken. Each of these tasks is potentially costly. Two key features determine the success of on-going regulation:

- **Observational difficulties.** To be effective, a regulator must be able to observe the level of precaution undertaken. It will be difficult to impose sanctions on infrastructure providers if performance measures can be manipulated easily, (see Milgrom and Roberts, 1992; Baker, 1992).
- **Regulatory commitment.** There may be changes that alter the regulator’s view of the optimal level of precaution. However, changes based on the past actions of infrastructure owners (for instance, easily achieved standards) may tempt regulators to ‘ratchet-up’ performance standards. Foreseeing this, infrastructure firms may not perform as well. Hence, on-going regulation requires commitment on the part of the regulator to previously set standards.

The key to the success of on-going regulation is the identification of appropriate levels of precaution and the ability to link these levels of precaution to sanctions if non-performance is detected. If either of these factors is difficult, on-going regulation will be less effective. On-going regulation also has the advantage of creating incentives for user investment in precaution. For example, a hospital might invest in back-up generation as a precaution against a power failure.

**Liability rules**

A liability rule specifies a set of sanctions or compensatory mechanisms that are triggered by actual realisations of interruptions to service. These include:

- **Strict liability rules.** Rules that hold infrastructure owners liable for the costs of all supply interruptions (regardless of how they are caused).
- **Contract damages.** Imposed contractual terms that specify the compensation that must be paid to users in the event of supply interruptions.

If specified correctly, each of these instruments has the potential to encourage socially optimal precaution on the part of infrastructure owners. Each is an obligation on infrastructure providers to ensure supply. If they cannot, then these mechanisms specify the penalty they must pay. If this penalty reflects the harm actually caused by the interruption, then a private infrastructure owner will internalise any social costs imposed by interruptions.

Liability rules, if working properly, have the key advantage of relatively low informational requirements. The only information required is an evaluation of the
actual harm done, which is observed when that harm is realised. Thus, information can be gathered \textit{ex post}. So no information on the precautionary actions undertaken by the infrastructure provider is required. Indeed, liability rules demand no \textit{ex ante} judgment on the levels of these actions whatsoever.

However, there are several conditions under which liability rules may not operate well:

- \textit{Incomplete enforcement}: for a liability rule to work properly, compensation based on actual harm faced must actually be paid. If the court system only weakly enforces the rule, too little supply security will be realised (Shavell, 1987). Similarly, if after the EC occurs the payments by the regulated firm are deemed to be excessive and reduced or subsidized by government, then a liability rule will not work properly.

- \textit{Limited liability}: if the magnitude of harm is larger than a firm capacity to pay it will limit the ability of a liability rule to encourage firms to internalise the costs of their actions (Shavell, 1984; Whittman, 1977).

- \textit{Risk aversion}: a liability rule means that an infrastructure provider is liable for interruptions even if they are not related to precautionary actions. This is a key part of the informational advantage of liability rules. However, risk-averse agents bear additional costs from these risks. This may raise the cost of capital to infrastructure and deter investment (Polinsky and Shavell, 1979).

- \textit{Many responsible agents}: liability rules presume that only the infrastructure provider is responsible for precaution, or that fault can be easily assigned if multiple players are involved. In reality, other agents, including users, regulators and even debt providers may also be responsible. Determining the optimal liability rule when this is the case is difficult (Pitchford, 1995).

- \textit{Governance issues}: interruptions are rare events. So while the probability of one occurring in a given year, five years or even a decade is small, over twenty or fifty years that probability becomes much higher. Precaution is likely to be effective in reducing probabilities of interruptions over that longer time horizon. However, the time horizon of infrastructure managers and equity holders is much shorter. So while the costs of precautionary actions are borne immediately, the beneficial consequences are not realised during the economic life of those decision-makers. This means that the incentive effects of a liability rule might be weak.

- \textit{Equity issues}: if the risky event is perceived as potentially severe, likely to cause substantial physical damage to humans, then there may be an emphasis on prevention rather than compensation in policy design. Community concerns regarding substantial environmental damage could also limit the scope for liability rules to be considered fully effective.

Each of these difficulties reduces the ability of a liability rule to ensure that decision-makers responsible for precautionary actions internalise the full social costs of those actions.
Combining instruments

Both on-going regulation and liability rules are imperfect instruments to promote precaution. The appropriate policy to promote optimal supply security will rely on each of these approaches to the degree that the marginal benefit of each approach is equated. This is likely to lead to a mixture of liability rules and on-going regulation unless one approach strictly dominates another for a particular regulated firm. The relative strengths, or alternatively the limitations of the different policies in influencing risk management practices, will drive the mix. The trade-off between the alternative policy approaches will depend on their relative efficiency. For example:

- How large is the magnitude of possible harm? If an interruption results in harm whose monetary value exceeds the ability of a corporation to pay (that is, it would go bankrupt first), then liability rules will be less effective.
- Are many agents responsible for precaution? If many agents are responsible, then liability rules are unlikely to be fully effective. However, if there is scope for negotiation among those responsible, such rules could be effective.
- How easy is it to evaluate the social costs and benefits of a precautionary action? If a government inquiry could establish that certain precautionary actions were worthwhile, then on-going regulation of their performance is desirable. If cost-benefit analysis is difficult or impossible before an EC then liability rules may be preferred.
- Is on-going monitoring of performance costly? If periodic performance monitoring of infrastructure providers is costly, it may not be easy to ensure that firms are complying with desired standards under on-going regulation.
- Do community standards regarding a desirable level of supply security change infrequently? If they are more or less constant over time, then the temptation of regulators to increase performance standards is reduced and on-going regulation is more effective.

Summary

In summary, there are two main approaches to deal with the decision to determine the level of *ex ante* precaution for extraordinary circumstances. The regulator can respond to the potential risk of an EC by:

- regulating actions to mitigate risks; or
- establishing liability for outcomes.

The choice between these alternative policies depends on the particular circumstances facing the regulator, including the information available to them and their ability to monitor precautionary activities over time. As we have indicated, legal, political and commercial limitations undermine sole reliance on liability rules.
The choice between regulatory alternatives and the degree of intervention depends fundamentally upon the nature of the interruption. The discussion above provides a basis for characterising the interruption and for determining whether policy instruments for risk regulation lie more with liability assignment or regulation of business practices.

**Compensation for Precautionary Activities**

In the previous section, we discussed alternative approaches to *ex ante* risk regulation. In particular, such regulation can involve liability rules or mandated standards. These alternative approaches have different implications for on-going price regulation of infrastructure firms. We explain each in turn.

**Liability rules**

Liability rules involve the regulated firm itself determining and carrying out the relevant precautionary activities. Given the liability rules set by the regulator and the probabilities associated with relevant events, the regulated firm will decide which precautionary activities to engage in and the extent of these activities. For many potential ECs, it will not be socially desirable to reduce the probability of an event to zero and even under strict liability rules it will often not be privately optimal for the regulated firm to reduce the probability of a particular EC to zero. In other words, the firm will optimally trade off the cost of precautionary activity with the probability of an EC and the cost to the firm of an EC.

As already noted, the advantage of liability rules is that they leave the degree of precaution to the firm itself and the regulated firm is likely to be in the best position to judge both the cost and effectiveness of different precautionary activities. At the same time, it needs to be recognised that using liability rules effectively requires the firm to self-insure against the possibility of an extraordinary event. The firm will undertake relevant actions to optimally mitigate the risk of an EC but will bear the residual risk (subject to the relevant liability rules) itself. Thus, using liability rules to deal with risk regulation is similar to requiring the firm to ‘self-insure’ against extraordinary circumstances.

How should the regulated firm be compensated for this self-insurance? From an economic perspective, the preferred approach would be to consider the actuarially fair premium for self-insurance and to allow the firm to recover that premium through its on-going pricing.

The efficacy of such an approach depends on the ability of the regulator to accurately measure the relevant insurance premium. It should be noted that under liability rules, the regulator cannot directly compensate the regulated firm for precautionary activities. There are two reasons for this. First, the precautionary activities chosen by the firm will often be difficult for the regulator to verify. Using liability rules reduces the information burden on the regulator, and having compensation based on actual precautionary activity simply reintroduces the information difficulties that liability rules are meant to avoid. Second, if the firm
under liability rules can choose its own level of precautionary activity and is
directly compensated for those activities, then the firm will choose an excessive
level of precaution. The cost of any precautionary activity is ‘refunded’ through
the regulated price of its goods or services, but increased precaution lowers the
risk faced by the firm. Thus from the firm’s perspective, direct compensation for
precautionary activities under a liability approach means that precautionary
activities have benefits but no costs. The firm will engage in too much precaution
from the social perspective.

An alternative to self-insurance under a liability approach would be for an
external party, such as the government, to effectively insure the firm. There are
significant benefits from such an approach in terms of risk pooling. A self-insured
firm is exposed completely to the idiosyncratic risks that face its industry. Under
a pooled insurance scheme, however, those risks are shared between all firms
covered by the insurance scheme. If the government effectively insured the firms,
then the government might seek to recover the implicit insurance premium directly
from the regulated firm or through broader tax instruments.

A significant problem, however, associated with ‘government insurance’ for
ECs is that, in its role of insurer, the government would most likely need to set
minimum precaution levels for the relevant firm and would need to monitor such
precautions. In other words, the government would have to move away from a
liability approach back to a regulatory approach based on strict standards. This
may be avoided to some extent by offering only partial insurance. In other words,
the government could offer EC insurance subject to a deductible that is borne by
the firm if an EC occurs. Of course, this is really just a mixture of ‘liability
regulation’ and ‘standards regulation’, being presented under another guise.

**Mandated standards**

If risk regulation is based on mandated standards, then the approach to
compensation for precautionary activity is likely to be significantly different.
Under a mandated standards approach, the government sets the required minimum
level of precaution and compensates the firm directly for its through the firm’s
regulated prices. These costs would most likely be set according to some
‘efficient’ standard to avoid regulatory manipulation.

Under a pure mandated standards approach, the regulated firm would face no
further liability for any community loss due to an EC so long as it had satisfied the
mandated standards. In this situation, the risk of an EC is borne by the
government and the community served by the regulated firm. In particular, if an
EC requiring government intervention occurred, the risk would be effectively
borne by the state tax payers.

It might be felt that a better approach to EC risk bearing would involve the
state adopting an insurance type approach. For example, the state government
could require that all regulated firms contribute to an extraordinary circumstances
fund each year. This fund would accumulate over time and would be used to fund
expenditure brought on by an EC (community assistance, community
compensation or sudden infrastructure expenditure). As noted above, a mandated standards approach exposes the government to EC risk. In effect, however, such a fund simply involves the regulated firm’s customers paying for the pool of funds to cover the costs of an EC. Also, the accumulation of these funds may face political risks, particularly if the EC fund became very large.

**Cost Recovery Following an Extraordinary Circumstance**

If an EC occurs, then there is likely to be significant expenditure borne by either the regulated firm or the government. The party that bears the expenditure depends on the exact nature of the liability rules established *ex ante*. In other words, the issue of *ex post* cost recovery cannot be separated from the issue of *ex ante* risk regulation.

To see this, consider a regime of strict liability. Under such a regime, the regulated firm determines the degree of precautionary activities and is compensated for both these activities and the risk it faces through a ‘self insurance’ premium or some other payment that the firm receives each year prior to an EC. But as the firm is ‘self insuring’, when an EC occurs the regulated firm would be required to bear the relevant EC costs without further compensation. The firm has already been effectively compensated for the *ex post* payments through the *ex ante* ‘insurance premium’ built into its prices.

Thus, under a strict liability approach, the firm is not compensated for any extraordinary expenditure associated with an EC. Rather, the firm itself must choose the appropriate way to tackle the EC. This may involve direct customer compensation, possibly tied in with customer incentives to minimise use of the relevant supply-constrained output. Alternatively, it could involve the regulated firm having to invest suddenly in substantial new infrastructure to overcome the supply interruption. The firm chooses the best way to limit the *ex post* damage associated with the EC because it is fully liable for this damage.

Note that this means that any capital investment made by a regulated firm in response to an EC under a strict liability approach would not be added to the firm’s asset base. Rather the firm would bear those costs entirely by itself.

Such an approach raises important practical issues. As noted above, if the payment is of a size that will bankrupt the firm, then placing the full cost burden on the firm is infeasible. Similarly, in the face of an EC, the government may face substantial pressure to ‘step in’ and ‘help out’ the firm and the community.

To the extent that the government does assist the regulated firm with cost recovery in the face of an EC, either directly or by allowing it to add emergency infrastructure to its regulated asset base, the risk of an EC is shifted back from the firm on to the government and the public. This undermines the incentive effects of the strict liability approach to risk regulation. It might also distort the regulated firm’s incentives when faced by an EC. For example, if the regulated firm is allowed to recover infrastructure expenditure due to an EC by adding this expenditure to its regulated asset base, but the firm is not allowed to recover once-
off customer compensation, then it will respond to an EC by building infrastructure, even if this is not the socially appropriate response.

Alternatively, consider the minimum standards approach to risk regulation. Under such an approach, so long as the regulated firm satisfies the minimum standards, it would generally not be held liable for any compensation or expenditure that is purely due to an EC. If an EC results in new infrastructure, then the funding of this infrastructure would be the responsibility of the government. The government would need to compensate a firm required to fund and build the infrastructure. If the government failed to compensate the firm, then it would be imposing EC liability on the firm.

When the response to an EC involves infrastructure expenditure, then this could be funded by rolling the infrastructure cost into the regulated asset base in full. However, this is simply one form of tax that can be used to pay for the infrastructure. Further, given the narrow base of such a tax, it would most likely be a highly inefficient tax. Effectively, such an approach would simply place all the risk associated with an EC (subject to the minimum levels of precaution being satisfied) back on to the community that suffers from the EC. Such an approach would not be consistent with the economic principles of good insurance as it would effectively prevent the local community from insuring against EC risk.

In summary, under a mandated standards approach, the burden of paying for a response to an EC, including any response that involved new infrastructure, would be borne by the State and would need to be funded through some mechanism. Funding could be through general revenue raising procedures (that is, debt or taxation), through an EC fund as discussed above, or through the local community by rolling the infrastructure into the regulated asset base.

Conclusion

The discussion above shows that ex post cost recovery must be consistent with the ex ante risk regulation. Ex post cost recovery and ex ante risk regulation are inextricably connected and it is impossible to just consider ex post cost recovery in isolation. The discussion also points out that practical regulation is unlikely to involve a ‘pure’ liability or a ‘pure’ mandated standards approach. Rather, a practical regulatory solution is likely to have elements of both approaches.

In practice, while regulators have tried to address the consequences of an EC when dealing with infrastructure firms, they have not, in general, adopted a consistent approach. Rather than thinking about the risk implications of these events in advance and incorporating relevant procedures into regulatory regimes, regulators have adopted an ad hoc mixture of pre-EC and post-EC policies. This is unlikely to lead to appropriate levels of precaution and increases uncertainty for both the regulated firms and the public as no one is sure in advance where liability for losses arising from an EC will fall. It creates poor incentives for regulated firms to undertake precautionary actions that ‘self-insure’ against the risks of an EC. These incentives are exacerbated if regulators mistake legitimate risk-
reducing investments as unnecessary cost padding and remove these investments from the regulated asset base.

At its worst, an *ad hoc* approach to dealing with the costs of an EC means that regulators, governments, regulated firms and the public, rather than knowing their role after an EC, each has incentives to try to force another group to react. The results can be draconian, as for example the use of a large number of inspectors checking that residential gas supplies had been turned off by householders and fining non-compliant households in the face of the Longford gas disaster in Victoria.

The key result from this paper is that regulators must act consistently both before and after an EC. Treatment of extraordinary circumstances for regulated firms is like a variety of other insurance problems. Regulators must embed optimal insurance into ongoing regulation to prepare for extraordinary events.

**References**


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REVIEW

The Knowledge Economy


Review by Don Lamberton

When Thomas Hodgskin in 1827 lamented that ‘the influence of knowledge was not noticed by economists till very lately’ (Hodgskin, 1827:3), he was not being entirely fair to, for example, Adam Smith and Dugald Stewart. Broadly speaking, however, questions about technology, that is, useful knowledge, were neglected in the classical period. In modern times there has been a flood of writing about the Information Revolution and, more recently, the Knowledge Economy but those efforts have, for the most part, focused on the acquiring of information machines, especially the telephone and the computer, rather than on the production, distribution and use of knowledge. It seems reasonable to say that a central role in economic analysis for knowledge has yet to be created.

The latest World Development Report 2005 drives home several points: reform is a process; more and better-directed government is needed; institutions must evolve; and ‘rent-seeking’ must be reduced (World Bank, 2004). The approach is to deliver the basics. But surely knowledge falls in this category.

The preamble to a book review does not permit detailed discussion but this major issue has to be put in perspective in order to do justice to Joel Mokyr’s superb book. Consider what Luigi Pasinetti said in his 1993 R. C. Mills Memorial Lecture (p. 3):

The reaction of economic theorists was most extraordinary. Instead of opening their eyes to reality and acknowledging, at last, the relevance of technical progress, they locked themselves into a theoretical castle. … Theorists withdrew all attention from dynamic problems ... and concentrated all attention on the typically static problems of the optimum allocation of existing resources.

He viewed this as ‘the most astonishing retreat from responsibility’.

Many difficulties have been encountered by theorists when they endeavoured to embrace a wider view of the information or knowledge economy. Economic theory did not cope well with what the actors knew and believed. Endogenous growth thinking ran into logical difficulties when competitive assumptions were relaxed. The major contributions can be traced in the writings of Fritz Machlup,
Kenneth Arrow, Joseph Stiglitz, Richard Lipsey and the OECD, to mention just a few.

Some of these difficulties are rather daunting. We are warned in the Preface to the New Economy Handbook (Jones, 2003) that the contributions making up its 1,095 pages are by economists ‘and fall, broadly defined, within the neoclassical paradigm’ (p.xxxvii). While the contributors seem to agree we have been living in ‘a truly extraordinary time’ (p. xi), they seem largely intent on pulling the problems back within the old theoretical framework in a further ‘retreat from responsibility’.

Even Charles Jones’ (2004) with his exciting title, Growth and Ideas, raises problems from his opening pages. Ideas are presented as instructions or recipes and they are treated as nonrivalrous. These thoughts can be questioned once we think of knowledge as capital, which, as Schumpeter (1953:61) taught us, ‘is neither homogeneous nor an amorphous heap. Its various parts complement each other in a way we readily understand as soon as we hear of buildings, equipment, raw materials and consumer’s goods’. And anyone who has grappled with the problems of accounting for and measuring knowledge must hesitate when presented with equations using an index of the knowledge in use and propositions about the total amount of knowledge and managed changes in knowledge.

Another NBER paper by Hausmann and Rodrik (2002) is a good reminder that the processes of knowledge creation and use seem to show discernible and disconcerting patterns. Knowledge is not just oil that lubricates an economic system. As the literature spawned by the tacit vs codified knowledge research has sought to show, ‘transfer’ efforts can lead to delays, mistakes, mismatches, and, of course, costs, as well as problems for researchers — some recent work includes: on the conceptual front, Boizot and Canals, (2004) and Lamberton (forthcoming); and on the measurement front, Grigorovici, Schement and Taylor (2004).

Against this background, Joel Mokyr’s superb book helps with these problems and argues that knowledge is the true base of civilization. For him, ‘The growth of human knowledge is one of the deepest and most elusive elements in history’ (p. 1). He can draw upon economics, history including the history of technology and science, and political economy. He is a former editor of the Journal of Economic History. The Gifts of Athena builds on his earlier The Lever of Riches.

Mokyr avoids entanglement in the webs of traditional theory. Central to his analysis is his concept of useful knowledge — which he acknowledges as going back to Simon Kuznets - pointing out that ‘Even ‘New Growth Theory’ which explicitly tries to incorporate technology as a variable driven by human and physical capital, does not try to model the concept of useful knowledge and its change over time explicitly’ (p. 4).

How then can a theory of useful knowledge be developed? Mokyr goes beyond the tacit vs codified dichotomy and distinguishes knowledge ‘what’ or propositional knowledge, i.e., beliefs about natural phenomena and regularities, which can be used to create prescriptive knowledge or techniques … a dichotomy
of *episteme* and *techne*, the former being the support for the techniques executed in economic production.

The dynamic complementarities with all their interactions between prepositional and prescriptive knowledge depict the rich history of innovation and growth of the dominant economies. These changes are traced through the Industrial Revolution (Ch. 3) and the Factory System (Ch. 4). In what I personally found most exciting, Mokyr brings his analytical approach to bear in Chapter 5: Knowledge, Health and the Household. Information and living processes have had profound effects on life expectancy. Evolving consumption patterns present very interesting challenges to neoclassical thinking, with some writers now arguing for a consumer-driven version of innovation and development. Some qualifications need to be added: business has always been willing to discriminate as finely as it was profitable to do so.

Chapters 6 and 7 turn to the political economy of knowledge: to innovation, institutions and the resistance to innovation. A broad perspective is set out:

Yet throughout history technological progress has run into an even more powerful foe: the purposeful self-interested resistance to new technology. Outright resistance is a widely observed historical phenomenon. Precisely because such resistance must work outside the market and normal economic process, artificial distinctions between the ‘economic sphere’ and the ‘political sphere’ for this class of problems are doomed. The political battles over technology have profound implications for economic history. One is that technological progress in a society is by and large a temporary and vulnerable process, with many powerful enemies with a vested interest in the status quo or an aversion to change continuously threatening it. The net result is that changes in technology, the mainspring of economic progress, have actually been rare relative to what we now know human creativity is capable of, and that stasis or change at very slow rates has been the rule rather than the exception. (pp. 220-221)

Mokyr sees ‘one of the main rediscovers of the new growth theory and recent thinking about economic development is the importance of institutions and politics’ (p. 282). Poverty traps, multiple equilibria, and inappropriate institutions can go together, ‘One type of such institution is the one that protects a technological status quo from would-be innovators’ (p. 283).

Salvation lies in the generation of new prepositional knowledge, ‘the fuel that keeps the engine of growth running’ (p. 283). The continuing expansion of useful knowledge is not guaranteed and so ‘the political economy of technological progress must occupy its rightful place at center stage’ (p. 283).

Clearly, Mokyr shows that historical perspective is essential. The challenge to economics is to fuse together the evolutionary economics thinking with the contributions of information economics that have been prominent in economic theory in recent decades. Most probably this will involve abandonment of a
unitary and all-purpose concept of knowledge and calls for efforts to move beyond what seem at first simple dichotomies like tacit/codified and prepositional/prescriptive knowledge. Knowledge is too diverse, elusive and important and we have yet to achieve a taxonomy based on its significant characteristics. *The Gifts of Athena* provides motivation and directions for that effort by seeking reasoned argument and empirically grounded findings rather than relying upon ideology.

**References**


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NON-AGENDA

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

—Jeremy Bentham (c.1801)

Are There Votes in Higher Taxes?

Andrew Norton

Political conventional wisdom assumes that tax cuts attract votes. Yet since the late 1990s the opinion poll evidence supporting this belief has weakened. In 1998, for the first time since 1969, a majority did not support 'less tax', when the choice was that or more spending on social services. By 2003, asked whether they would forgo tax cuts or pay higher tax to fund health and education services majorities said ‘yes’. Anomalies exist — a belief that the top marginal tax rate is too high, for example — but too many surveys from too many polling organisations say similar things to doubt the general trend. Tax is less unpopular than in the past.

Unsurprisingly, supporters of big government are keen to enlist these results in their cause. The ACTU (2003) highlighted its own poll showing that ‘the community values public provision of health and education ahead of individual tax cuts’. Shaun Wilson (2004), a left-leaning academic and key public opinion researcher in this field, interprets the results as saying that ‘the public wants its government to follow enlightened social democracies elsewhere and invest in their future’. John Quiggin (2004), a prominent left-of-centre economist, hopes that these polls mean ‘that social democracy has won the public debate, at least for the moment’.

Politicians seem less convinced. In the May 2004 Budget, the Coalition government announced tax relief for people earning over $52,000 a year, and no significant new spending on health and education, though in the lead-up to the October 2004 election increased health spending was announced. The ALP Opposition passed these tax cuts, and promised to reduce taxes for people earning

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less than $52,000 a year if it won office. Opposition Leader Mark Latham (2004) went so far as to say, in his reply to the Budget, that Labor would reduce ‘Commonwealth expenditure and Commonwealth taxation as a proportion of GDP’.

The politicians seem to think that talk is cheap — that it is easy for voters to tell pollsters that they want to pay more tax, but that in reality there would be an electoral price to pay. As professionals in the business of politics they know that there are many real and potential problems with opinion polls, which is why they like to say that it is only the poll on election day that counts. Some reasons why they might be right in thinking that tax increases are not a prudent electoral strategy are explored later in this article. However, first it is argued that there has in fact been a shift in public opinion about taxing and spending, though not for the reasons suggested by other recent analysts of these trends.

The Polls

Long-term trends

Since 1967, in a series of slightly varying questions, voters have been asked about their relative preference for reducing tax or spending more on social services. These surveys are not in themselves good guides for politicians. They omit an option that is always popular if available, the status quo. They leave implicit the higher tax corollary of more spending, and the lower spending corollary of less tax, creating an artificial choice between two positives. They ask about what the government should do, not whether the respondent personally wants less tax or more social services. As we will see, these issues are potentially significant. These surveys’ value lies in tracking broad tendencies in opinion over a long period of time, letting us hypothesise more confidently about their links to real-world trends than we can from one-off polls with very different questions.

As can be seen in Figure 1, the peak in pro-service spending opinion occurred in the late 1960s, and lasted for two surveys. By the time voters were asked again about their relative preferences for taxing and spending, in 1974, support for more spending had halved and twice as many respondents as before wanted less tax. In the mid-1980s the lower tax option increased its popularity, with very few people wanting more social service spending. Though the anti-tax view subsided from its 1980s peak in the first half of the 1990s, it was still a majority position, and support for more spending remained at low levels. In the second half of the 1990s, opinion began to change, with less tax trending down and more spending trending up. By 1998 ‘reducing taxes’ was a minority position, though still a larger minority than ‘spending more’. In 2003 a question similar to those of 1967-2001, but one which replaced the vague ‘social services’ with ‘services like health and education’ gave spending a plurality on 48 per cent, with 28 per cent for less tax. A year on, a 2004 Saulwick-Muller poll came out with near even support for less tax and fewer services (45 per cent) and more tax and more services (44 per cent), the more tax option being six percentage points higher than it had been in
the same poll in 2001. This poll’s question and response options differ from those in the time series, but it shows the same broad trends (Saulwick and Muller, 2004).

**Figure 1: Long-Term Trends in Opinion on Taxing and Spending**

![Graph showing long-term trends in opinion on taxing and spending](image)

**Questions:**
- 1967, 1969 and 1979 ANPAS surveys; 1984-1986 National Social Science Surveys; 1987 and 1993-2001 Australian Election Survey: If the government had a choice between reducing taxes or spending more on social services, which do you think it should do?
- 1974 Morgan Poll: If you had to choose between the federal government increasing social services or reducing taxes which would you choose?
- 1990 Australian Election Survey: Some people think that the federal government should reduce taxes a lot and spend much less on social services. Others think that the federal government should increase taxes a lot and spend much more on social services. And others have opinions in between. Where would you place yourself on this scale?

Where grades of support for taxing and spending were available, in all polls from 1986-87 onwards, responses have been aggregated. Following the practice of other researchers, the 1984 and 1986 National Social Science Survey ‘mildly for’ more taxing and spending have been translated as being equivalent to ‘depends’ in subsequent surveys. The argument for doing so is that there is a consistently large minority (20-32 per cent) of equivocal respondents who choose this option, so including them in either lower tax or more spending overstates support for these options.

**Recent one-off surveys**

Other surveys over the last two years also show support for more spending. A 2003 ACNielsen survey taken after the May Budget changed the choice from alternative principles to alternative proposals. The Budget offered a small tax cut, equivalent to $4 a week for middle-income earners. Of those polled, 20 per cent preferred the tax cut, and 77 per cent wanted the money from the tax cut to go to ‘services such as health and education’ (Stirton, 2003). Though the tax cut’s trivial size may have affected the trade-off, this was a strong pro-spending result.
for a survey that reminded its respondents that government expenditure was not
costless.

Later in 2003, the Australian Survey of Social Attitudes (ASSA) looked at
spending priorities and personal willingness to pay, again prompting respondents
to consider the potential personal financial consequences of their answers. It
found 68.2 per cent were willing to pay extra tax to spend more on health and
Medicare, 63.5 per cent for schools, 54.6 per cent for defence and national
security, and 53.8 per cent for environmental protection. All up, 73 per cent
nominated at least one area in which they were prepared to pay more tax (Wilson
and Breuch, 2004:110).

Newspoll arrived at a similar result in January 2004. It asked ‘If the federal
government has a large surplus, should this be spent all or mainly on health and
education, on personal tax cuts, or spent on both equally?’ and 72 per cent of
respondents said it should be spent all or mainly on health and education, nine per
cent supported tax cuts, and 14 per cent wanted it spent on both equally. All up,
88 per cent favoured at least some additional spending. The numbers were a little
lower in a Taverner Research poll of voters in NSW and Victoria after the May
2004 Budget. This Budget offered generous payments to families as well as tax
cuts for people earning over $52,000 a year. When its respondents were asked
whether they would forgo the tax cuts and family incentives for spending on
services 65 per cent said ‘yes, definitely’, 14 per cent wanted some of each, and 18
per cent wanted the tax cuts (Hudson, 2004). The two pro-spending options add
up to 79 per cent, comparable to ACNielsen and ASSA results in 2003.

On-line polling conducted by researchers from the Australian National
University on behalf of *The Bulletin* during the 2004 federal election campaign
confirmed that opinion still favoured tax increases (Gibson, 2004). When asked if
they would be willing to pay higher taxes so that the government could afford to
spend more on health and Medicare 69 per cent of respondents said that they were.
Majority affirmative responses were also received for education (51 per cent),
environmental protection (55 per cent) and defence and national security (52 per
cent).

**Explaining Discrepancies**

While all polls conducted on taxing and spending issues over 2003 and 2004
arrive at similar conclusions, there is an anomaly that needs explaining. The most
general 2003 question about reducing tax or increasing spending on services, from
the ASSA, shows 48 per cent support for the more spending option. That is at
least 24 percentage points lower than levels recorded in other polls, despite the
general question only implying that more services meant more tax, and not
mentioning at all that the respondent’s personal tax bill may be higher. How is
this to be explained?
Specific spending

Part of the answer is that voters have reasonably clear ideas about which parts of the Budget should receive more resources. When the 2003 ASSA, for example, looked at five specific outlay options, 73 per cent of respondents nominated at least one of these for additional taxing and spending, but only 27 per cent wanted more in all five areas.

Other poll evidence confirms impressions from the 2003 ASSA and the January 2004 Newspoll that health is a high priority. Over many years the Morgan Poll has asked its respondents about what are the most important issues the federal government should be doing something about (a national issue), and what the federal government could do that would be of most benefit to them and their families (a personal issue). As Figure 2 shows, health has increased very significantly as a top issue since the early 1990s. The difference between the national and personal levels is exaggerated, since for the national question respondents are specifically asked for three issues, while no number is mentioned for personal replies (respondents can give more than one answer, but in practice few do). Newspoll’s surveys also show that health has become a more important issue (Grant, 2004:18).

Figure 2: The Rise of Health as an Issue

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Question 1: Thinking about Australia as a whole. In your opinion, what are the three most important things the federal government should be doing something about?

Question 2: What could the federal government do that would be of most benefit to you and your family?

Source: Morgan Poll.

Because people know which services they want tax money spent on, they do not give unqualified support for more spending. In the 2003 ASSA a question that asked about spending on ‘services like health and education’ received a lower response than questions asking about either of those two services individually
(68.2 per cent for health, 63.5 per cent for education). Only 57 per cent of the sample, however, replied affirmatively to both specific questions indicating that some people with limited pro-tax and spend views were presumably deterred by mention of a service that they did not want money spent on, and shifted their preference to ‘depends’, an option nominated by 21 per cent of respondents.

Vague questions, like those asked in the surveys that make up Figure 1, are likely to reduce pro-spending opinion. Questions which do not specify that the money is going to services that the respondents want, or raise the possibility that it might be spent on things that they do not want — ‘services like [but not only] health and education’(emphasis added) — receive more negative answers than tightly-worded questions focusing attention on services respondents do want.

The psychology of the surplus

Most Budgets in the Howard-Costello era delivered surpluses, collecting more in tax and other government revenue than they spent. This reversed the budgetary pattern of the preceding 25 to 30 years. Since the mid-1970s, in most years governments spent more than they collected, and filled the gap with borrowing. The issue here is whether this fiscal turnaround changes the way people think about taxing and spending issues. Is spending more attractive if it does not require any new taxes, tax rates, or tax brackets? Are voters more likely to reject a tax cut paid out of the surplus than to accept a tax increase from an in-balance budget?

In strict personal financial terms, a surplus should not make a difference. A forgone $20 a week tax cut out of a surplus has the same effect on personal finances as a $20 tax increase from a balanced budget — the taxpayer is $20 a week worse off. However, psychologically the two are not necessarily the same, and rejecting a tax cut is more likely than accepting a tax increase. This is because the taxes that finance surpluses are already factored into taxpayers’ financial calculations. Rejecting a tax cut will not interfere with otherwise anticipated spending by a taxpayer. A tax increase, by contrast, would reduce forecast spending capacity. It hurts less to lose something you did not expect to have than to lose something you did expect to have.

The psychology of the surplus helps explain differences between the 2003 ASSA and the May 2003 ACNielsen poll. The 2003 ASSA omitted mention of a budget surplus and, as noted, 57 per cent of its respondents replied affirmatively to paying more tax for both health and education. The May 2003 ACNielsen poll, by contrast, found that 77 per cent of voters preferred the $2.4 billion allocated to tax cuts to go to health and education (Stirton, 2003). That is 20 percentage points more support than for the same spending options when funded from increased personal tax, consistent with spending being less painful when it comes out of the surplus, even when accompanied by a lost tax cut.

Similarly, support for spending was above 57 per cent in other polls that referred to or assumed knowledge of the surplus. The January 2004 Newspoll, which specifically mentioned the surplus, came out 15 percentage points ahead of the 2003 ASSA for spending on a comparable combination of services, and 31
percentage points higher if the money was to be split between spending and tax cuts. The May 2004 Taverner poll, also in the context of a Budget with a surplus but not directly reminding its respondents of it, found 65 per cent for more spending on services rather than the tax cuts, and 14 per cent for some of each. It had the lowest margin over the 2003 ASSA, eight percentage points, probably because it did not specify popular health and education spending.

Framing losses

The factored-in cost (from the taxpayers’ point-of-view) of the surplus also changes how losses and gains are perceived. The psychological literature on loss aversion finds that, in normal circumstances, losses loom larger than gains (Kahneman, Knetsh and Thaler, 2000). To put it another way, most people are more upset about losing $100 than they are happy about gaining $100. When extra money is taken from voters in tax, it will be seen as a loss to the taxpayer. However, when the money is already held by the government (or will be held, given current tax rates and revenue projections) not spending the money on services becomes the ‘loss’ in people’s minds, rather than paying tax. There are signs of this phenomenon in recent polls.

The May 2003 ACNielsen poll, taken after that year’s Budget, is a possible example. It was well known that the tax cut was only $4 a week for average earners. In this context, it was easy to see the lost health and education services as exceeding the small gain from lower income tax, so 77 per cent went for more health and education spending. Similarly, the January 2004 Newspoll’s question framed the issue as tax cuts or services financed from a surplus. Because the surplus was the status quo, the negative of a potential loss of health and education services outweighed the positive of a tax cut.

For people who are net beneficiaries of the tax and social service system the 2004-05 Budget was easily framed as a ‘loss’. They receive negligible or no benefit from a tax cut, and therefore lack a gain on the tax side of the tax and spend choice. A Newspoll published in The Australian after the May 2004 Budget shows how these people can be losers without losses. Though the Budget contained no spending cuts, 22 per cent of those polled proclaimed themselves to be ‘worse off’ as a result (Shanahan, 2004). Ignorance may explain some of these replies, but other voters possibly believed that with a large surplus they were entitled to a share of it, and failure to receive that share was a ‘loss’.

A second question in the January 2004 Newspoll illustrates the effect of framing losses particularly well. As we have seen, only nine per cent of its respondents wanted the surplus spent all or mainly on tax cuts. But its next question asked whether the tax rate of 47 per cent on incomes over $62,500 was too high. 50 per cent said it was, 34 per cent said it was about right, and just 8 per cent said it was too low. If the strict logic of answers to the first question were carried through a 50 per cent too high response would be unlikely, since without those high rates the projected surplus would not have been so large. Yet this
second question was phrased to emphasise losses for taxpayers. The way the two questions were asked generated intuitive but inconsistent answers.

Another example of how framing the issue to emphasise the cost to taxpayers produces anti-tax results comes from an ACNielsen/CIS poll in August 2003. This survey told respondents how much taxpayers on $30,000, $60,000 and $120,000 paid in tax, and asked whether this sum was too high, too low, or fair and reasonable. Put in these terms, the constituency for lower tax changes, from 9-20 per cent in the three questions premised on the surplus, to 41-46 per cent, depending on the income group (Saunders, 2004:9). Taxes mentioned in isolation are seen as losses to taxpayers. Just 1-9 per cent, again depending on the income group, thought that the tax paid was ‘too low’, well below the 27 per cent wanting more taxing and spending in all five areas suggested in the ASSA being conducted at the same time. The difference was that ACNielsen poll talked only about tax, focusing attention on tax losses, while the 2003 ASSA talked about taxes and services.

Such are the contradictory impulses about gains and losses prompted by different questions that when offered the status quo more respondents choose it above either lower tax or more spending alternatives. The status quo was also the most popular option when Figure 1 showed ‘less tax’ to be in the majority when answers were restricted to two alternatives. A 1979 Age Poll found that 61 per cent of respondents wanted the budgetary status quo, while 20 per cent wanted less tax. This contrasts with 59 per cent for reduced taxes when the choice was between less tax and more spending. Another Age Poll in 1985, just prior to the anti-tax peak in Figure 1, found 22 per cent preferring less tax and 57 per cent supporting the status quo (Grant, 2001:237-38). In 2000, the International Social Science Survey found 42.6 per cent support for the status quo, 30 per cent support for more taxing and spending, and 24.7 per cent for less (Withers and Edwards, 2001:13). This approximately matches the more spending option in the 2001 AES, but shows 20 percentage points lower support for less tax.

What results from the one-off surveys suggest is not ideology, but opinion that is acutely sensitive to context. Often, this context is nothing more than the question asked and which concerns it makes salient. The importance of question wording has always to be kept in mind when analysing these polls. Question wording cannot, however, explain the trends recorded in Figure 1, because the questions asked were similar (the main differences are the absence of ‘it depends’ or ‘mildly’ options prior to 1984). Broader social, economic or political circumstances must be driving changing responses to questions that are the same or very similar.

Underlying Causes

The importance of health

The polls discussed so far suggest that the main reason support for tax has gone up is that voters want more money spent on health and education. One possible
reason for this preference is that they believe these services are getting worse. Table 1 shows that a majority of voters believe there has been a decline in the standard of health service and a plurality think that the standard of public education has declined. In their article analysing the 2003 ASSA, Shaun Wilson and Trevor Breusch (2004) find that, after controlling for other factors, those who believe that health and Medicare have declined in the last two years support more spending by half a point more on a five point scale, and those who think public education has declined move toward more spending by a third of a point. Those who think both have declined move by three-quarters of a point. Richard Grant’s (2004:25) paper also takes the view that support for more spending ‘probably reflects the need to redress the perceived decline in health service standards’.

### Table 1: Perceptions of Service Standards

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<tr>
<td>Stayed the same</td>
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<tr>
<td>Fallen</td>
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<td>42</td>
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Note: The increased and fallen responses have been aggregated, and all figures rounded.

This explanation of opinion trends assumes that what is new is declining service standards, or at least a perception of declining standards, which in turn prompts voters to the conclusion that government spending must rise, drawing on the surplus or new taxes. But what if this perception is not new? A constant cannot explain something that varies over time. Polling conducted over many years suggests that far from dissatisfaction with health and education services being something that developed suddenly between 1996 and 1998, it is a phenomenon that appears regularly in the polls.

Though earlier questions about health did not ask about trends, we can infer from their answers that health services were a major concern. Back in 1984, when
the polls were strongly for less tax, the National Social Science Survey (NSSS) nevertheless found that 57 per cent of people believed that too little was spent on hospitals and medical care. The 1987-88 NSSS found 70 per cent wanted more spending on ‘health, hospitals and medical care’. In the 1990 Australian Election Survey, 89 per cent classed health as an important issue, but 51 per cent disagreed with increasing tax to finance more health spending. It took the direct threat of more tax to push health down the list of priorities.

Other sources confirm health services were important before the strong pro-tax and spend polls of the last two years. Right from the time Newspoll started measuring opinion on health and Medicare in July 1990 it has been an important issue, with a debut on 63 per cent. It was at 85 per cent in October 2003 when the 2003 ASSA was being conducted. It did not show as highly significant in the Morgan Poll until later because economic issues, especially unemployment, were seen as more critical when poll respondents were permitted only three ‘most important’ issues. As the economy subsided as a concern, underlying concerns about health services rose to the top of the public’s agenda.

It is conceivable that dissatisfaction with the quality of health services is the dynamic influence on public preferences; that over the last few years we reached a tipping point that reversed opinion on taxing and spending. Perhaps the demographic and technological changes driving up health costs finally overwhelmed the system and the public’s patience. But a more plausible interpretation might be that health services have been a major concern for a long time without any dramatic effects on opinion about government spending. From 1986 to 1996, support for more spending overall was below 20 per cent — a number that doesn’t match with the concern shown in specific questions about health during this time. As late as 2001 less tax had a trending down, but still comfortable, 12 percentage-point lead over more spending. Voters undoubtedly want health services to improve, but this fact on its own does not fully explain the trends we see.

The impact of prosperity

An alternative theory of tax and spend trends is that what varies is not the desire for better health and education services — this is an underlying constant — but the capacity to pay for them. In other words, prosperous people want to buy additional health and education services, along with other new or improved goods and services, which they forgo when they feel less well-off. Richard Grant, Shaun Wilson and Trevor Breusch correctly identify negative perceptions about health and education services as a necessary condition for voters supporting more taxing and spending, but miss that these perceptions are not on their own a sufficient condition for opinion to change.

If we look back on the long-term history of opinion on taxing and spending, going back to the late 1960s (Figure 1), this theory fits more closely with the trends we see. The last time we saw strong pro-spending opinion was in two surveys conducted in 1967 and 1969. This was a period of strong real wage
growth. If people judge their financial situation by comparing it with the past then at that time they should have felt prosperous. Contemporary opinion polls suggest that they did, as seen in Table 2. Two Morgan polls conducted in 1966 and 1967 found that hospitals and medical services topped the list of most important election issues, with education second, just as they have again since 2001. In these circumstances, it is plausible that in the late 1960s Australians wanted to increase their overall consumption, and for services (like health and education) where government was the dominant financier, they accepted that the mechanism for doing so was more taxation.

<table>
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<tr>
<th>Year</th>
<th>Better off</th>
<th>About the same</th>
<th>Worse off</th>
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<td>1967</td>
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<td>20</td>
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<td>1969</td>
<td>43</td>
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By the time Australians were next asked about their preferences for taxing and spending, in 1974, opinion had changed markedly, against spending and for less tax. What drove this shift? Perhaps the Whitlam government’s spending increases satisfied some demand for more services. A consequence of increased spending was that the tax burden rose from 22.5 per cent of GDP in 1972 to 25.9 per cent of GDP in 1974 (OECD, 2003:73-74). Though real wages were still growing, by the mid-1970s, the marginal tax rate on average weekly earnings exceeded 40 per cent (Warren, 2004:108). Additional tax hit many families’ finances, and consistent with what we would expect if household finances were the main variable, support for less tax greatly increased.

At the time of the mid-1980s anti-tax peak in opinion, as seen in Figure 1, households’ overall financial situation was worse than in the 1970s. Wage increases were not keeping pace with the cost of goods and services. Average income tax rates trended up to a record peak in the late 1980s, and the marginal tax rate on average weekly earnings exceeded 40 per cent for several years from 1985 (Warren, 2004:108). In 1983, the McNair polling organisation asked ‘during the last few years has your financial situation been getting better, getting worse, or has it stayed the same?’ — a similar though not identical question to that asked in

1 Morgan Result supplied by Richard Grant. There had been a House of Representatives election in 1966 and a Senate election in 1967. The question format differs from the later Morgan Polls in Figure 2, as respondents were asked about what would affect their vote rather than which issues the federal government should be doing something about, and they were given a list of 11 issues to choose from, rather than being asked to nominate their own issues.
the late 1960s. 48 per cent said worse off, 36 per cent said the same, and only 14 per cent thought that they were better off (McNair, Anderson 1983). In 1987, a twelve-month comparison in the Australian Election Survey found 43 per cent thought that they were worse off, 38 per cent said the same, and 19 per cent said they were better off. The public chose lower tax over more spending, needing financial relief more than additional services. Consistent with this, as can be seen in Figure 2, few people rated health as one of the top three issues the federal government should be doing something about.

The overall household financial situation in the later 1990s and early 2000s was quite different. Real wages grew strongly from the mid-1990s, easing financial pressure on households. After the Howard government’s 2000 tax reforms the marginal tax rate on average weekly earnings was 30 per cent, less than it had been through most of the 1970s and 1980s. Consumer confidence surveys, such as those carried out by Roy Morgan Research since 1973, show that people did perceive their financial situation in the way the objective statistics suggest they might have. From 1984 to 1987, the period of the anti-tax peak in opinion, confidence declined significantly and, apart from one exception in 1988, did not exceed its baseline 100 index until 1993. Since 1994, the consumer confidence index has not dropped below 110, and has exceeded 120 since 2002 (Roy Morgan Research, April 2004).

**Figure 3:** Consumer Confidence and Preference for Social Service Spending

![Figure 3: Consumer Confidence and Preference for Social Service Spending](image)

Source: Consumer confidence data is from ‘Fall in April but Consumer Confidence Still High: Monthly Roy Morgan Consumer Confidence Figures - 1973 to present’, Article No. 320, 16 April 2004.

Spending data: As for Figure 1.

We are back where we were in the late 1960s. Voters feel more prosperous than they did in the 1970s and 1980s, and want to buy more goods and services, including those services primarily financed through government. Figure 3 shows that for nearly a thirty-year period consumer confidence and support for spending
on social services broadly track each other, as we would expect if financial circumstances are the key variable driving trends in tax and spend opinion.

**The View from Parliament House**

If tax cuts are less popular than at any time since the late 1960s, and extra spending, especially on health, has high support when paid for from increased tax and overwhelming support if financed from the surplus, why did the 2004-05 Budget not follow those preferences, and why did Labor also include tax cuts in its policy package?

*Tax cuts are short-term, but spending is long-term*

So far there is little evidence that voters’ preferences are undergoing an enduring change. The force driving the polls is not ideology but prosperity. Without strong economic growth consumer confidence will drop and budget surpluses disappear. With the preconditions of pro-spending opinion gone, public preferences could quickly change. Since 1967 that has already occurred twice over five year periods, 1969 to 1974 and 1998 to 2003. If these poll results survive hard economic times then we can conclude that underlying opinion is different. Until then, the safer hypothesis is that recent survey results reveal a stage in a longer-term cycle, not a new resting point. Political leaders need to think of the longer-term consequences of anything they do now, and what options they will have if circumstances change.

Of the three options in the 2004-05 Budget — more spending, deficit reduction, tax cuts — more spending is the most politically difficult to adapt to a weaker economy. This is because while tax cuts and more spending can have the same effect on the current year’s fiscal outcome, they have different longer term dynamics. Tax cuts mean that revenue is lower than it would otherwise have been, but cuts of the kind announced in the 2004-05 Budget do not disrupt the tax system’s capacity to generate ever-increasing revenue from the same rates. This dynamic improves the Commonwealth’s fiscal position. Spending increases, and especially those increases that create new entitlements also tend to grow, but these worsen the Commonwealth’s fiscal position.

The progressive tax system can increase revenue even in a stagnant economy. With inflation, workers are pushed into higher tax brackets without any politically difficult tax increases. In a growing economy, real income increases push more workers into higher tax brackets, while tax rates stay the same. Due to these factors the proportion of taxpayers in low tax brackets — paying a top tax rate of 30 per cent or less — decreases each year by 1.5 to two percentage points, all without the government doing anything (Warren, 2004:110). Despite the tax cuts, the 2004 Commonwealth Budget predicts real tax revenue growth of 2.7 per cent in 2004-05 and 2.3 per cent in 2005-06. Only serious recessions, such as those in the early 1980s and early 1990s, reduce tax revenues in real terms.
The expenditure side of the Budget lacks the tax system’s self-correcting (from the Commonwealth’s view) mechanisms. To the contrary, it has self-expanding systems, causing spending to rise continually. Demographic change means that some areas of Commonwealth spending, such as old age pensions, cannot easily be controlled. Without controversial policy changes, the relatively easy qualifying terms for single parent and disability support benefits are likely to generate further growth in welfare dependency.

For politicians trying to manage economic and electoral cycles, moderate tax cuts are the safer option, causing fewer long-term fiscal problems.

Private truths, public lies

Voters tell pollsters that they favour more tax for more services, but how strongly do they hold this opinion? For some voters, their answers may reflect not deep beliefs, but what they think other people believe. They are bandwagon responses. With several well-publicised polls over 2003 and 2004 showing popular support for more spending, we have the basic precondition of a bandwagon effect. Bandwagon answers are not lies, but they are so superficial that a change in real-world events (such as taxes going up) could see these respondents switch sides very easily.

Other respondents may have firm preferences that they conceal for reasons of social acceptability. This is the ‘private truths, public lies’ phenomenon described by Timur Kuran in his book of that name (Kuran, 1995). With a national consensus that public services should be a top priority, nominating something else, especially something self-enriching like tax cuts, looks selfish. In these circumstances, some people give the answer they feel they should give, the socially or politically safe response, not what they genuinely believe.

The Morgan Poll ‘most important issues’ surveys give us some insight into differences between public and private opinion on political issues. By inquiring about what would benefit the respondent and his or her family, as well as what should be done for Australia, there is a question that minimises pressure to give the socially acceptable response — especially as the personal question is asked second, after good citizen bona fides are established. As Figure 4 indicates, tax is always more often nominated as something that the federal government could do for respondents and their families than it is nominated as a national issue.

The last two years are particularly interesting. While all other polling data suggests that tax levels are less of an issue than in the past, tax has increased significantly as a personal and family issue. This is consistent with, but not proof of, some voters telling ‘public lies’ that conceal their true policy preference. It could be that the minority who want tax cuts rank that issue above all others. Whatever the correct interpretation, Figure 4 warns politicians of a constituency still very concerned about how much tax they are paying, despite the pro-tax impression given by other polls.
Figure 4: Tax as a National and Personal/Family Issue

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Per cent

Question 1: Thinking about Australia as a whole. In your opinion, what are the three most important things the federal government should be doing something about?

Question 2: What could the federal government do that would be of most benefit to you and your family?

Note: Until 1999, all tax responses were classified by Morgan as ‘lower tax’. After that, ‘no GST’, ‘tax reform’ and ‘other taxation issues’ were added. This creates difficulties in drawing trend lines. In that period ‘lower tax’ as a personal issue drops significantly, but taxation issues more broadly are stable. Pre-1999 some complaints about the tax system were probably coded as complaints about tax levels, though prior to the GST it is unlikely that this was a major factor. At least some of ‘no GST’ could probably be re-classified as a complaint about tax levels. The particular point of interest here, results from 2003 on, is unaffected by these changes.

Source: Morgan Poll.

What, me?

It is easy to say sincerely that other people should pay more tax. This is one reason why retirees, who have largely ended their taxpaying years, are much more in favour of spending than workers (Wilson and Breusch, 2004:111). But in addition to those who will never suffer the financial consequences of their preference, some people who support higher tax may do so because they believe that they will not pay, or will not pay much. However, many people erroneously believe that they are not in the top group of relatively high income-earners who pay most of Australia’s income tax. Research by the Social Policy Research Centre at the University of New South Wales shows that many affluent Australians significantly underestimate their position in the nation’s income distribution. When asked which income decile they were in, only two per cent of those in the top 20 per cent of earners located themselves correctly (Saunders, 2002:204-05). These people may change their preference after the first Budget that increases taxes.
Others volunteering the ‘wealthy’ to pay more tax may not realise that, due to high marginal tax rates on modest incomes, they will end up paying more themselves in the near future. Neil Warren (2004:111) estimated, using the tax scales applying before the 2004-05 Budget, that as early as 2005 the average worker will move into the 42 per cent marginal tax rate (though of course their average tax rate will be much lower, because most of their income will taxed at 30 per cent or less). Average workers paying marginal tax rates above 40 per cent were a feature of strong opposition to more tax in the 1970s and 1980s, and there are signs that marginal tax rates are still an issue, such as the January 2004 Newspoll which found 50 per cent thought that 47 per cent tax above $62,500 a year was too high. The Howard government’s tax cuts delayed expanding the base of taxpayers paying high marginal tax rates.

Another difficulty is that as voluntary taxation creates free-riders, tax cannot be targeted on those willing to pay. Even for relatively popular spending priorities like health and education, we still see between one-quarter and one-third of voters in the 2003 ASSA saying that they are not willing to pay any more tax. In their analysis of that survey, Wilson and Breusch (2004:108-09) note that those without any political party identification are more in favour of tax cuts than other voters. These are also the people whose votes are most likely to swing in an election campaign, and the subject of political attention disproportionate to their numbers.

**Conclusion**

Like other recent analyses of public opinion trends, the preceding analysis finds that there has been a real shift in public opinion toward more spending on health and education and against lower taxes. That six pollsters asking a range of differently worded questions received similar answers gives us confidence that the trends identified in Figure 1 are real, and not the result of an idiosyncrasy of any particular survey. It is more difficult to be confident about the scale of this shift, because results are highly sensitive to context. This, however, does not show incoherence in opinion; rather it shows that the precise nature of the trade-off between the two alternatives matters, as we would expect from a rational voter.

The paper agrees with the other main papers — Grant (2004) and Wilson and Breusch (2004) — that the perceived quality of health and education services is a major factor. However, this is seen as a constant factor in voters’ calculations, rather than the variable driving opinion change. Instead, economic prosperity is seen to have given voters the capacity to satisfy their preference for better health and education services. This has significant consequences for the interpretation of

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2 A referee inquired about the influence of socio-economic and other characteristics on attitudes. Wilson and Breusch (2004) show that these vary in largely predictable ways, according to ideology and financial interest. However, they do not argue that overall trends are driven by sub-groups either changing their views dramatically or their share of the overall population. Opinion is moving more quickly than social change and by more than any one sub-group could trigger, so it is agreed that we need to look elsewhere for explanation.
the political implications of this opinion shift. It does not seem likely that support
for more spending will survive an economic downturn — economic rather than
ideological change is most important. It follows that politicians need to be wary
of making commitments that they cannot easily take back if opinion changes, or if
opinion turns out to be insincere, or if voters wrongly assume that someone else
will pay. At least for the meantime, opinion has changed, but these are polls
politicians should not rush to act upon.

References

So as not to clutter the text with referenced, I have not individually noted precise locations
of data from the Australian National Political Attitudes Survey, the National Social
Science Survey, the Australian Election Survey, or the Australian Survey of Social
Attitudes. These are all available from the Australian Social Science Data Archive at the
Australian National University, http://assda.anu.edu.au/, along with full bibliographic
details and information about sample sizes. Newspoll’s results can be found at
http://www.newspoll.com.au. More recent Roy Morgan polls can be found at

ACTU Congress.


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Sydney.


My work on this subject owes much to discussions with Richard Grant, his PhD thesis, and his archive of opinion polls. Christian Gillitzer, Peter Saunders and two anonymous referees offered useful suggestions for improvement. The usual disclaimers apply. A longer version of this paper is available at www.cis.org.au.