

Deregulatory Irresponsibility: the Unintended Consequences of Failure to Regulate

Geoff Bertram
Institute of Policy Studies
16 February 2010

Four Key references

- Graham Scott *et al*, *Report of the Regulatory Responsibility Taskforce*, September 2009,
<http://www.treasury.govt.nz/economy/regulation/rrb/taskforcereport>
- Lewis Evans and Neil Quigley, *Compensation for Takings of Private Property Rights and the Rule of Law*, 21 October 2009.
- Amartya Sen, *The Idea of Justice*, Harvard University 2009.
- Arnold Harberger, “Three Basic Postulates for Applied Welfare Economics: An Interpretive Essay”, *Journal of Economic Literature* 9(3) September 1971, pp.5-20.

Are the 6 principles “broadly accepted principles of good legislation” as the Taskforce asserts?

I shall argue, from the standpoint of an economist, that the answer should be no.

- In their present form, several of the principles are extremist in their implications for policy
- Several fundamental requirements of good legislation are missing entirely from the Taskforce’s list and apparently will have to be defended before the courts every time they are implemented
- Both the deficiencies in the principles as proposed, and the gaps in the list, boil down to the absence of a satisfactory underlying theory of justice and hence of the proper function of government and legislation

Points to be made in the paper

- **Compensation for “taking or impairment of property”**
 - “full’ compensation” versus “just compensation”
 - No “due process” qualifier
 - No clear limitation on “property”
 - Slavery, the welfare state, and progressive taxation: whether “takings” should be compensated at all depends on the particular circumstances
 - Adam Smith on the role of government
- **Transfers are virtually never welfare-neutral**
 - No policy that is not pareto-improving can be evaluated by economists without weighting the various interests affected
 - Economic theory has failed to come up with any non-arbitrary weighting arrangement
 - “a dollar is a dollar” is a common but arbitrary weighting scheme based on practical convenience, not economic theory
 - Mainstream economic theory has nothing to say about the justice or otherwise of transfers
 - Policymakers do not have to answer to economists (nor to the courts) for their value judgments on distributional issues

Outline of key points (continued)

- **Cost benefit analysis must not be taken beyond its well-established limits**
 - “the benefits of ... legislation” are usually unquantifiable
 - Costs should always be assessed so far as possible, but whether they are outweighed by the benefits is not for economists to say, outside very narrow limits
 - The Kaldor-Hicks compensation criterion does not map the outer boundary of welfare-improving change
 - Harberger, Coase, Williamson, Little and Mirrlees on evaluating redistributions of income and wealth
 - Are those who ignore the history of economic theory condemned to repeat past errors?
- **“Transcendental institutionalism” and its critics: Amartya Sen looks at Rawls and Nozick**
 - The importance of reasonableness
 - The gulf between reasonableness and actual behaviour
 - Light-handed regulation in New Zealand since 1985 is a case study in this distinction
 - Some unintended consequences of failure to regulate in New Zealand under neoliberal policy
 - Likely unintended consequences of using red tape to “fight red tape”

Limitations of cost-benefit

- Cost benefit is an effective tool only within a restricted domain;
- Key elements of most policy decisions require the exercise of judgment on matters where economic theory is necessarily silent;
- Cost-benefit cannot answer ethical questions – it can only help identify efficient and effective ways to implement ethical judgments once these have been reached; and
- Winners being able to compensate losers may be a sufficient condition for approving a policy, but it is not a necessary one

Task Force Principle (c):

“(c) *Taking of property* – legislation should not take or impair, or authorize the taking or impairment of, property, without the consent of the owner, unless it is necessary in the public interest **and full compensation is provided to the owner**, such compensation to be provided, to the extent practicable, by or on behalf of the persons who obtain the benefit of the taking or impairment”

US Fifth Amendment:

“No person shall be ... deprived of life, liberty, or property, **without due process of law**, nor shall private property be taken for public use, without **just compensation**.”

Justice has always mattered to the great economists

- Adam Smith's three-legged stool:

“According to the system of natural liberty, the sovereign has only three duties to attend to; ... first, the duty of protecting the society from violence and invasion of other independent societies; **secondly, the duty of protecting, as far as possible, every member of the society from the injustice or oppression of every other member of it, or the duty of establishing an exact administration of justice**; and, thirdly, the duty of erecting and maintaining certain public works and certain public institutions which it can never be for the interest of any individual, or small number of individuals, to erect and maintain... “

Wealth of Nations Book IV Chapter ix

“[T]he key political economy question is this: Is there a government that, having attained power to implement their agenda, would then be willing to impose on itself the discipline of weighing private costs from the taking of rights against an explicit assessment of the claimed public benefits **through a requirement to compensate the private loss**? This is obviously a task for a statesman or woman with an understanding of both economics and the law....”

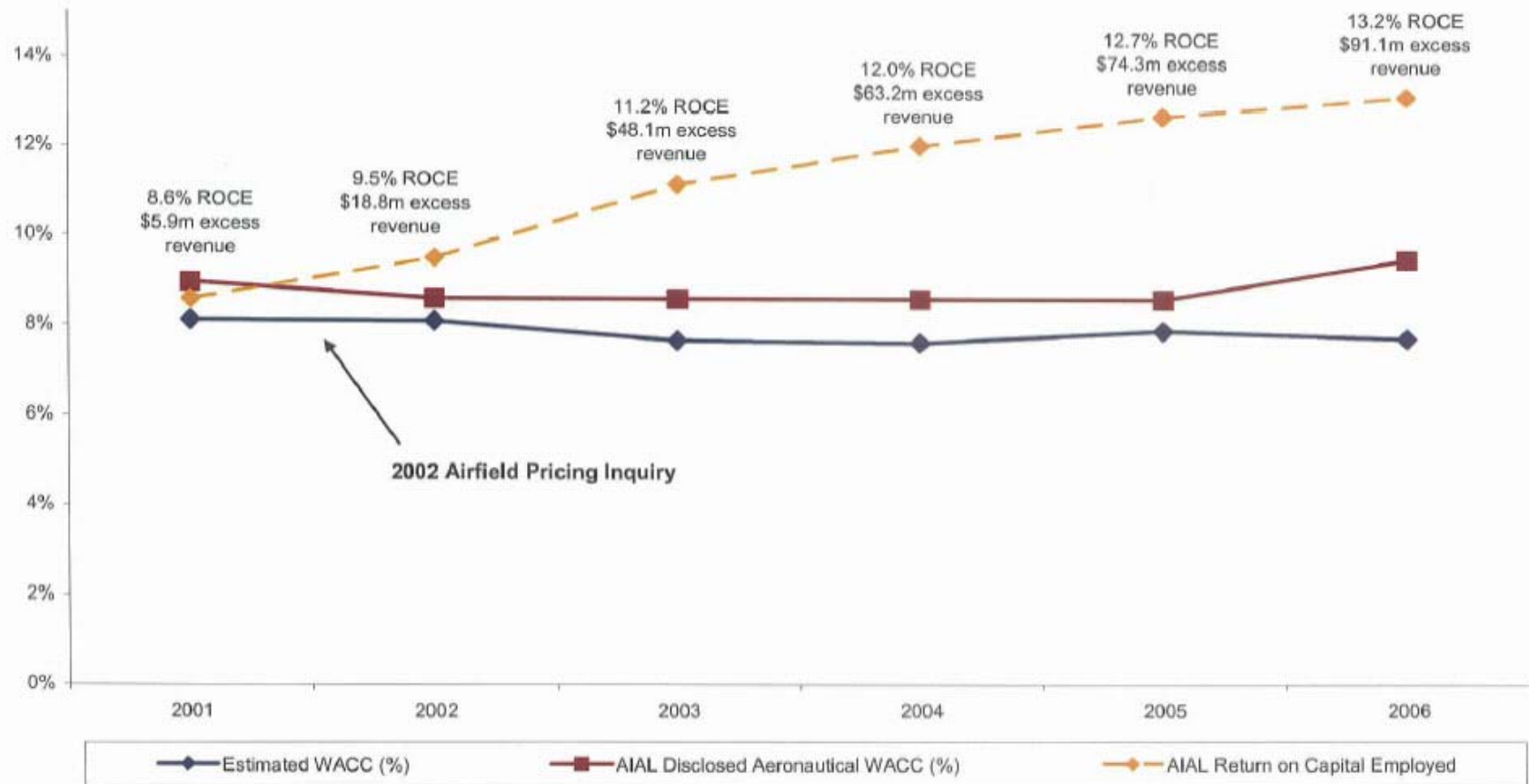
(Lewis Evans and Neil Quigley, *Compensation for Takings of Private Property Rights and the Rule of Law*, 21 October 2009, p.33.)[Emphasis added]

The Evans-Quigley list of “takings” is actually pretty extensive (2009 p.1)

- “Government interventions that result in uncompensated takings of property rights span planning and land use, industry-specific regulation, promotion of the welfare state, restrictions on the nationality of ownership and on business strategies of major New Zealand companies as part of the national economic planning agenda, and imposition of the values of politicians...”

AIAL's return on capital employed compared to WACC on a consolidated basis

AIAL's Consolidated Return on Capital Employed Compared to WACC (DHC Asset Values)



Source: Company Reports, Public Information, PwC Analysis

PwC, Air New Zealand Ltd Review of Returns of Auckland International Airport Ltd, July 2007, p.20.

AIAL total capital employed



Wealth transfers are fundamental to much good legislation

- The fact is that cost-benefit analysis cannot illuminate any such issue until some prior judgment calls have been made:
 - firstly to enable different individuals' interests to be weighted, aggregated and compared in quantitative terms; and
 - secondly to provide some quantitative value for things that are simply inherently unquantifiable. To date mainstream economic theory has come up with no satisfactory (broadly accepted) way of doing either.

Rawls on justice

“(a) Each person has the same inderefeasible claim to a fully adequate scheme of equal basic liberties, which scheme is compatible with the same scheme of liberties for all; and

(b) Social and economic inequalities are to satisfy two conditions:

- **first, they are to be attached to offices and positions open to all under conditions of fair equality of opportunity; and**
- **second, they are to be to the greatest benefit of the least-advantaged members of society (the difference principle)”**.

“All systems either of preference or of restraint, therefore, being thus completely taken away, the obvious and simple system of natural liberty establishes itself of its own accord. Every man, **as long as he does not violate the laws of justice,** is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or order of men.”

(Adam Smith, *Wealth of Nations* 1776, Book IV Chapter IX paragraph 51)

- The modern welfare state emerged from the attempt in European and North American societies to achieve Smith’s removal of “preference or restraint”, in order that the “system of natural liberty” could flourish.
- To remove all trace of “preference”, the income distribution across classes and across individuals must be in accord with some underlying scheme of justice in distribution.
- To remove all “restraint”, it is necessary to prevent or countervail any exercise of market power which impinges upon the efficient and fair allocation, and productive use, of scarce resources.

“... [E]ven in his own day, when it was not so easy to see, Smith saw that self-interest and competition were sometimes treacherous to the public interest they were supposed to serve, and **he was prepared to have government exercise some measure of control over them where the need could be shown and the competence of government for the task demonstrated. His sympathy with the humble and the lowly, with the farmer and the laborer, was made plain for all to see. ...his prejudices, such as they were, were against the powerful and the grasping, and it was the interests of the general masses that he wished above all to promote**, in an age when even philosophers rarely condescended to deal sympathetically with their needs... He did not believe that laissez faire was always good, or always bad. **It depended on circumstances; and as best he could, Adam Smith took into account all of the circumstances he could find.**”

Jacob Viner, “Adam Smith and Laissez-Faire”, *Journal of Political Economy* 35(2): April 1927, pp.231-232. 16

Rosenberg concurs

“A central, unifying theme in Smith's *Wealth of Nations* ... is his critique of human institutions on the basis of whether or not they are so contrived as to frustrate man's baser impulses ("natural insolence") and antisocial proclivities and **to make possible the pursuit of self interest only in a socially beneficial fashion**. Indeed, it will become apparent below that Smith's basic argument applies to the whole spectrum of social contrivances and is not restricted to economic affairs. **The question is, in each case, whether institutions do, or do not, harness man's selfish interests to the general welfare**. This is, of course, the basis of Smith's critique of mercantilism.”

Nathan Rosenberg, “Some Institutional Aspects of the *Wealth of Nations*”, *Journal of Political Economy* 68(6): 557-570, December 1960, p.560.

“[I]f a collective defines public purposes by acting through political, legislative, executive and judicial means, then the values, purposes and goals defined in these processes become a different standard for judging what is publicly valuable than the simple aggregation of the welfare of those affected by the public policies. In an important sense, our legislative, executive and judicial branches set out what could be described as ‘public purposes’ (or in more economics-oriented language, ‘social maximands’) when they pass a law, issue an administrative ruling, or make a precedent-setting judicial decision. At each of these moments, a representative government institution makes a choice on behalf of a collective about an important public value that is to be protected or advanced through the use of the powers, the assets, and the capacities of the state. **It is that choice that becomes the important arbiter of what constitutes public value, not the welfare of the individuals affected by the choice.**”

(Moore, M.H., “Public Values in an Era of Privatization - Introduction”, *Harvard Law Review* 116(5): 1212-1228, March 2003, p.1220.)

- It is ironic that hostility to “uncompensated takings” of private property comes from much the same groups that have pushed the “total surplus standard” in cost-benefit analysis of mergers and profit regulation in New Zealand, and captured the Commerce Commission:
 - “[A] net public benefit analysis considers net total welfare effects. Under this analysis, any deadweight efficiency loss due to allocatively inefficient prices would count as a net public detriment, but **any transfer of wealth from consumers to suppliers (or vice versa) would not.**”
 - “[E]xcess returns being reduced, with a transfer of wealth from suppliers to consumers ... [would constitute] a net benefit to acquirers. [However] **[t]he increase in consumers’ wealth is matched by a reduction in suppliers’ wealth (resulting in zero net public benefit).**”

Commerce Commission, *Guidelines to the Analysis of Public Benefits and Detriments*, October 1994 (revised December 1997), Wellington.

Where did that idea come from? Time for some history of economic theory

- From Smith to Pigou, leading economists agreed that there were occasions on which the state ought to intervene to redistribute wealth
- The principle of diminishing marginal utility, when applied to income under the assumption that individual utilities could be added together, produced a strong presumption in favour of complete equality as the social optimum
- Robbins (1931) and Hicks (1934, 1938) rescued economics from this commitment to radical redistribution by denying that economists could say anything at all about the welfare implications of the distribution of wealth or income.

- Fundamental to Robbins and Hicks was the notion that interpersonal comparisons of utility are impossible, from which it followed that cost-benefit analysis could never prove that taking a dollar from a rich person and giving it to a poor person is welfare-improving for society as a whole.
- Welfare economics and its applied version, cost-benefit, was thus disqualified at the outset from being able to resolve the most fundamental policy issues facing the legislator.
- That left the difficult question of whether economic theory could ever identify policies that were welfare-improving

- Two answers were forthcoming:
 - Pareto improvements (no losers, some winners, so no necessary tradeoff)
 - Potential Pareto improvements where there are some losers, but the winners can afford to compensate them and still come out ahead. This is the Kaldor-Hicks criterion
- Neither of these makes it possible for the economist to say any particular policy is bad, because they are only sufficient conditions for a policy to be good - not necessary conditions

- Inevitably, neoclassical economists were unwilling to abandon the policy field to those who were willing to enter into the political (as distinct from economic) business of redistributing wealth and power.
- The welfare state shifts wealth and power in favour of the poor and the weak, on the basis of an explicit political judgment that this is a good thing to do. Nothing in neoclassical economic theory demonstrates the contrary
- Conservative ideologues may agonise over the allegedly dire incentive effects of taxation upon the enterprising rich, or the allegedly debilitating incentive effects of welfare dependency for the poor.
- But whether those claims are true or false is an empirical question, not something that theory can resolve.

- **Neoclassical economists re-entered serious policy debate by adopting as basic principles a couple of highly contentious, and usually false, propositions.**
 - “A dollar is a dollar”: no welfare weight can be assigned to the transfer of a dollar from one person to another. This meant that cost benefit could make progress by following the trail blazed by national-accounts statisticians.
 - The distribution of wealth and income must already be optimal by assumption, for if it were not, the government could be relied upon to change it separately from the policy under consideration, so that the applied economist could proceed to disregard the distributional impact of any policy.
 - That entails a prior assumption that the government is all-wise, all-powerful, and infallible – for if these properties are not possessed by government, then one cannot assume without further enquiry that the existing income and wealth distribution is optimal. (Public-choice theory is obviously logically inconsistent with this.)

Harberger

“[W]hile the highway engineers can apply professional standards to characteristics such as thickness of base, load-carrying capacity, drainage characteristics, and the like, characteristics such as scenic beauty are beyond their competence as professional engineers. In the same way, any program or project that is subjected to applied-welfare-economic analysis is likely to have characteristics upon which the economist as such is not professionally qualified to pronounce, and about which one economist is not professionally qualified to check the opinion of another. These elements – which surely include **the income-distributional ...aspects of any project or program may be exceedingly important, perhaps even the dominant factors governing any policy decision, but they are not a part of that package of expertise that distinguishes the professional economist from the rest of humanity.**”

Arnold Harberger, “Three Basic Postulates for Applied Welfare Economics: An Interpretive Essay’, *Journal of Economic Literature* 9(3): 5-20, September 1971, p.785.

More Harberger....

- “If we are to take a (hopefully justified) professional pride in our work, we also must have the modesty and honesty not to claim for our profession more than we are particularly qualified to deliver.”

Arnold Harberger, “Three Basic Postulates for Applied Welfare Economics: An Interpretive Essay’, *Journal of Economic Literature* 9(3): 5-20, September 1971, p.786.

“Hypothetically, one might contemplate a national income measure incorporating ‘distributional weights’ but two obstacles stand in its way: **first the impossibility of achieving a consensus with regard to the weights**, and second, the fact that most of the data ... are aggregates in the first place, and do not distinguish the individuals or groups whose dollars they represent. Giving equal weight to all dollars of income is mathematically the simplest rule.”

Arnold Harberger, “Three Basic Postulates for Applied Welfare Economics: An Interpretive Essay’, *Journal of Economic Literature* 9(3): 5-20, September 1971, p.787.

Coase

“If it is decided to use a pricing system, there are two main problems that have to be solved. **The first is how much money each individual consumer shall have - the problem of the optimum distribution of income and wealth.** The second is, what is to be the system of prices in accordance with which goods and services are to be made available to consumers-the problem of the optimum system of prices. **It is with the second of these problems that I am concerned in this article. The first is partly, though not entirely, a question of ethics.** But it is important to realise that there are these **two** problems and that both have to be solved if a pricing system is to produce satisfactory results. As I am in this section dealing with the second only of these problems, **I shall assume that the distribution of income and wealth can be taken to be the optimum”**

R.H. Coase, “The Marginal Cost Controversy”, *Economica*, New Series, 13(51): 169-182, August 1946, p.172.

Williamson

- “For specific welfare valuations, ... we might not always wish to regard consumer and producer interests symmetrically-although since, arguably, antitrust is an activity better suited to promote allocative efficiency than income distribution objectives (**the latter falling more clearly within the province of taxation, expenditure, and transfer payment activities**), such income distribution adjustments might routinely be suppressed. If they are not, the tradeoff between efficiency gains and distributive losses needs explicitly to be expressed....
- “Note in this connection that the transfer involved could be regarded unfavorably not merely because it redistributes income in an undesirable way (increases the degree of inequality in the size distribution of income), but also because it produces social discontent. This latter has serious efficiency implications that the above analysis does not take explicitly into account... Distinguishing social from private costs in this respect may ... be the most fundamental reason for treating claims of private efficiency gains skeptically.”

Oliver E. Williamson, “Economies as an Antitrust Defense: The Welfare Tradeoffs”, *The American Economic Review*, 58(1): 18-36,. March 1968, p.28.

- “[T]he political implications of the control over wealth involve a judgment of how the quality of life in a democracy is affected by size disparities. The latter is less easily (or even appropriately) expressed in efficiency terms. The issue is nevertheless important.”

Oliver E. Williamson, “Economies as an Antitrust Defense: The Welfare Tradeoffs”, *The American Economic Review*, 58(1): 18-36,. March 1968, p.29.

- Recall that Harberger's rule "a dollar is a dollar" in not a claim that transfers have no welfare impact. It is a claim that economists, as economists, have nothing to say about those welfare impacts.
- So policymakers are not accountable to economists for value judgments about the distribution of income or wealth, because economists have explicitly abdicated from those value judgments and left them to policymakers

Transcendental institutionalism and Sen's critique

- According to Sen, Rawls, like most contractarians, is wrong to think that the solution he has identified to the problem of choosing an ideal set of institutions behind a veil of ignorance is unique
- Once a just set of institutions has been established, it remains to be seen whether the individuals upon whose agreement the whole edifice rests will behave “reasonably”, in the sense of (i) acting in a way that sustains the institutions, and (ii) refraining from doing things that subvert the institutions.

Rawls on reasonableness

- [R]easonable persons are ready to propose, or to acknowledge when proposed by others, the principles needed to specify what can be seen by all as fair terms of cooperation. Reasonable persons also understand that they are to honor these principles, even at the expense of their own interests as circumstances may require, provided others likewise may be expected to honor them. **It is unreasonable not to be ready to propose such principles, or not to honor fair terms of cooperation that others may reasonably be expected to accept; it is worse than unreasonable if one merely seems, or pretends, to propose or honor them but is ready to violate them to one's advantage as the occasion permits"**

John Rawls, *Justice as Fairness: A Restatement*, edited by Erin Kelly, Harvard University Press, 2001, pp.6-7

Sen on reasonableness

[E]ven if we do accept that the choice of basic social institutions through a unanimous agreement would yield some identification of 'reasonable' behaviour (or 'just' conduct), there is still a large question about how the chosen institutions would work in a world in which everyone's actual behaviour may or may not come fully into line with the identified reasonable behaviour. [I]f the justice of what happens in a society depends on a combination of institutional features and actual behavioural characteristics along with other influences that determine the social realizations, then is it possible to identify 'just' institutions for a society without making them contingent on actual behaviour (not necessarily the same as 'just' or 'reasonable' behaviour)?

Amartya Sen, *The Idea of Justice*, Harvard University
2009, p.68

- [I]t can be argued that the relationship between social institutions and actual – as opposed to ideal – individual behaviour cannot but be critically important for any theory of justice that is aimed at guiding social choice towards social justice” (Sen p.69)
- Rawls’s presumption [is] that once the social contract has been arrived at, people would abandon any narrow pursuit of self-interest and follow instead the rules of behaviour that would be needed to make the contract work. Rawls’s idea of ‘reasonable’ behaviour extends to the actual conduct that can be presumed once those chosen institutions – unanimously chosen in the original position – have been put in place. (Sen p.79)
- Demanding more from behaviour today than could be expected to be fulfilled would not be a good way of advancing the cause of justice. (Sen p.81)