

## **Deregulatory Irresponsibility: the Unintended Consequences of Failure to Regulate**

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### **Outline**

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. Apart from its implicit adoption of “property-rights fundamentalism” the Task Force report casts no light on the issues of fairness/equity/justice which are central to real-world policymaking.

The central points I want to make are the following:

- **Compensation for “taking or impairment of property”**
  - “full’ compensation” is not the same as “just compensation”
  - The Task Force’s wording has no “due process” qualifier
  - No clear limitation is set out on the precise definition of “property” or “property rights”
  - Slavery, the welfare state, and progressive taxation demonstrate that whether “takings” should be compensated at all depends on the particular circumstances
  - Adam Smith makes “the administration of justice” one of the three key roles of government, and what he means by justice is indeed fairness, protection of the poor and weak against the rich and powerful
  
- **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
  - Elected policymakers therefore do not have to answer to economists (nor to the courts) for their value judgments on distributional issues
- **Cost benefit analysis must not be taken beyond its well-established limits**
    - “the benefits of ... legislation” are usually unquantifiable to a large extent
    - 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 confirm that redistributions of income and wealth cannot be judged from within neoclassical economic theory
    - 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**
    - Reasonableness (as distinct from rationality) is central to making contractarian ideas workable
    - The gulf between reasonableness and actual behaviour is therefore a key problem for what Sen calls Transcendental institutionalism
    - 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”

## **Introduction**

My aim in this paper is to address critically certain key aspects of the Taskforce report, and at the same time to suggest that the whole package comes with entirely the wrong body language, if the intention really is to improve the quality and effectiveness of legislation and regulation in this country. The Taskforce, in common with previous neoliberal manifestos on constitutional and governance matters, starts from a prior hostility to government *per se*, a desire to rein in the extent of state intervention in economic and social matters<sup>1</sup>, and an apparent prior commitment to property-rights fundamentalism.

Consequently, the six “principles of good government” around which the recommendations hang are strongly biased against any extension of government activity, and carry a presumption that any policy intervention (especially one that offends the business community’s sensitivities) is guilty until proven innocent. A heavy and essentially undemocratic burden of proof<sup>2</sup> is thrust upon officials and ministers carrying out their normal duties under democratic mandate. The proposed procedures for discharging that burden of proof seem designed, whether intentionally or not, to have high transaction costs and to trigger repeated confrontations between the Courts and the elected government of the day. Far from “cutting red tape”, the proposed Bill would create a morass of new red tape<sup>3</sup>. Players with deep enough pockets to afford high-powered lawyers would be able to use the measure to obstruct government attempts to regulate their activities, and this is the core of my concern with the Bill and the Report.

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<sup>1</sup> Task Force *Report* p.8 para 1.2 “there can and should be less legislation...”

<sup>2</sup> Task Force *Report* p.6 para B.I “broadly accepted principles of good legislation, incompatibility with which is justified only to the extent that it is reasonable and can be demonstrably justified in a free and democratic society”. It is not stated what the standard of reasonableness is, nor to whom exactly and to what standard of proof a policy has to be “justified”.

<sup>3</sup> Task Force *Report* p.8 para 1.4 “statements of responsible regulatory management for each proposal for a new Act or regulation, signed off by the relevant Minister, chief executive and control agency...”; p.19 para 2.16 “the potential benefit ... significantly outweighs the additional compliance costs placed on the Government by the Bill” [same point p.20 para 2.24]; p.19 para 2.29 “the introduction of the RR Bill will raise public sector administrative costs...”. There is, rather conspicuously, no serious analysis or estimation by the Task Force of the scale of the costs, nor demonstration of the quantified benefits.

It is simply not true that responsible regulation means less or none. Responsible regulation means effective regulation, targeted tightly and effectively at people whose activities deserve regulation. Sometimes that will mean less, and sometimes more.

Because time is limited, I confine my comments today to elements of just two of the principles: the proposition that any “taking of property” should be accompanied by mandatory full compensation, and the notion that all legislation must be subjected to some sort of prior certified cost-benefit analysis<sup>4</sup>. Both of these are, I suggest, likely to prove recipes for bad legislation and bad government, and I do not believe them to be as “broadly accepted” as the Taskforce would have us believe – at least, if the test of broad acceptance is the wider voting public rather than the Taskforce membership itself.

New Zealand has now completed two decades of regulatory and legislative changes motivated by the “less is better” view of government, which in its day was advocated largely on the basis that government interventions tend to have “unintended consequences” which, if fully anticipated, should persuade policymakers not to proceed. One of my concerns in this paper is to redress the balance a bit by drawing attention to the consequences of inaction and the costs that have flowed from inaction, deregulation, “light-handed” government policy, and the persistent promotion by the neoliberal Right of an ideological distaste for the entire exercise of government *per se*.

My personal view is that the costs of regulatory inaction can be extremely high, and in particular that the case for light-handed regulation of big business that was made out by lobbyists and officials in the late 1980s and early 1990s was hopelessly over-optimistic about the prospects that good corporate citizenship would flourish in a climate of governmental self-restraint. I shall come back to this when I discuss Sen’s critique of Rawls

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<sup>4</sup> I note in Tim Smith’s paper to this symposium the assurance that the Task Force did not intend that any formal benefit-cost analysis be required for the purposes of certifying compliance with the “principles of good legislation”, but I fear that in practice this is exactly where we would be heading.

and “transcendental institutionalism” and the importance of Rawls’ own assumption of “reasonableness” in individual behaviour.

I have a second theme related to the proper application of cost-benefit analysis and of the Hicks-Kaldor compensation principle. Far too great a burden is placed in neoliberal writings on the notion that cost-benefit somehow offers a means of resolving issues involving deep policy choices<sup>5</sup>. Economists have known for half a century now that

- cost benefit is an effective tool only within a restricted domain; that
- key elements of most policy decisions require the exercise of judgment on matters where economic theory is necessarily silent; that
- 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 that
- winners being able to compensate losers may be a sufficient condition for approving a policy, but it is not a necessary one

### **Takings, Impairment and Compensation**

A case in point is the issue of transfers of income and wealth. The Taskforce’s principle (c) recommends mandatory, unqualified full compensation for any “taking or impairment” of a property right when this is justified in the public interest:

(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;

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<sup>5</sup> A useful review of the neoconservative misuse of cost-benefit analysis in the Republican campaign to subvert high-quality regulation in the USA from Reagan onward is in John B. Judis, “The Quiet Revolution: Obama has reinvented the state in more ways than you can imagine”, *The New Republic* 1 February 2010, <http://www.tnr.com/article/politics/the-quiet-revolution> . The New Zealand Business Round Table has promoted similar practices here.

Even when the public interest requires property to be “taken” or “impaired”, the Task Force contemplates no situation where “full compensation” might not be paid. Compare this with the wording of the US Fifth Amendment which requires only “just compensation”:

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.

The US wording leaves open the possibility that there can be situations in which justice may point to no compensation, or partial compensation. The extreme wording adopted by the Taskforce conspicuously avoids using the word “just”, which would raise the question of what justice is and what it may require.

Remember that Magna Carta was the founding document not only of the English common law and Bill of Rights doctrines regarding private property, but also of feudalism, a social and economic order that proved unsustainable, both because it was an obstacle to economic progress and because it embodied significant elements of injustice.

Recall that the 5<sup>th</sup> Amendment to the US Constitution was adopted in 1789, at a time when slavery was considered fully compatible with Enlightenment thinking and Magna Carta. It was more than half a century before slavery was abolished, in one of the more spectacular uncompensated takings of the nineteenth century. The slavery example reminds us that notions of what can be and what cannot be “property rights” have evolved over time, as conceptions of justice have moved along with human progress. Once one abandons the idea that people can be the private property of others, the right of dispossessed slave owners to be compensated evaporates - because compensation is not required by justice.

Justice has been a central concern of major economists in the past. Here’s Adam Smith:

“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

Neoliberal commentators and analysts in New Zealand have consistently argued over the past two decades that transfers of wealth or income have no welfare consequences – a matter I return to shortly - which means that their conception of “policy justified by the public interest” is tightly constrained to policies which expand the total flow of goods and services available to the community, and does not allow for the possibility of net welfare gains from uncompensated takings. So-called ‘economic efficiency’ thus becomes the be-all and end-all of legitimate policy. The narrowing of focus since Smith is dramatic.

To see where this narrowing of “economic” discourse leads, consider the following passage from a recent paper by two New Zealand economists<sup>6</sup>:

[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....”

The suggested “discipline” would obviously prohibit any policy or legislation that simply set out to redistribute income and wealth within the community, with no effect on output (or possibly some negative effect on output).

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<sup>6</sup> Lewis Evans and Neil Quigley, *Compensation for Takings of Private Property Rights and the Rule of Law*, 21 October 2009, p.33.

Let us be clear: the welfare state involves uncompensated taking from some to give to others. If all such taking had to be fully compensated the redistribution would be nullified and the project aborted. If, like me, you think the welfare state was one of the twentieth century's greatest historical achievements, you will be worried at any extreme claim that all takings (not to mention "impairments", however that is to be understood) must be fully compensated, for such a requirement would remove government at a stroke from the business of remedying rank injustice in the distribution of the benefits from economic activity. Precisely such an outcome has been, I fear, in the minds of some of the proponents of the Regulatory Responsibility Bill.

Evans and Quigley (2009), for example, include "promotion of the welfare state" in their list of "Government interventions that result in uncompensated takings of property rights" (p.1). They acknowledge (p.33) that one of the arguments against the sort of measures the Taskforce recommends "is that a wider protection of property rights would unreasonably constrain a modern government in the exercise of actions that were in the public interest." This indeed is the argument I am making here. But they then go on, in the passage I quoted earlier, to treat the Hicks-Kaldor compensation criterion as the outer limit of good legislation, rather than as merely a sufficient condition for judging a policy to be a member of the much wider set of good policies. Their confusion of necessary with sufficient conditions for policy to be good policy seems very much in tune with the thrust of the Task Force Report. I detect here a risk that those who ignore or forget the history of economic theory may find themselves falling into a repetition of past errors.

I note that one of the four examples cited by the Task Force to illustrate alleged lack of regulatory responsibility (*Report* para 2.11 pp.17-18) is "(d) the rejection by Government Ministers of the proposal by the Canadian Pension Plan Investment Board to acquire up to a 40% shareholding in Auckland International Airport Limited..."

The saga of AIAL has been a case study of the propensity of smart businesspeople in this country to take over privatized infrastructure assets and convert them to cash by (i) price-gouging the users of the assets, (ii) revaluing the assets to the new “fair value”, and (iii) selling them off, in a country where there has been no effective regulation, no capital gains tax, and (until the case the Task Force complains of) no serious obstacle to cashing up ill-gotten (but entirely legal) gains by selling out to overseas investors with deep pockets. The Commerce Commission fingered AIAL for excess profit taking back in August 2002 and recommended price control under Part IV of the Commerce Act. The Commission’s report<sup>7</sup> was exhaustive in its treatment of the economics and very favourable to the airport in its estimates of the costs of regulation. While the excess profits estimated by the Commission were not dramatically large (\$4.5 million excess on revenues of \$45 million in the late 1990s), this case was critical in establishing expectations about the effectiveness of Part IV of the Commerce Act. Both the Act and the Commission’s reputation were on the line. The Government sat on the recommendations till May 2003, when Minister Lianne Dalziel let the company roll on unregulated, in one of the defining moments of light-handed regulation<sup>8</sup>.

Price Waterhouse Coopers in 2007 estimated that excess returns were by then running at \$91 million per year, once the airport’s unilateral asset revaluations (effectively uncompensated takings from airport users by a monopoly supplier) were properly accounted for<sup>9</sup>. PWC found that total shareholder return March 2000-July 2007 was 32.9% compounding p.a. – that is, \$1 invested at March 2000 would have grown to \$7.90 by July 2007 assuming all dividends were reinvested.

My own estimate of excess profits, taking account of a 1999 revaluation excluded from PWC’s study period, was \$120 million per year. If we take

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<sup>7</sup> Commerce Commission, *Final Report Part IV Inquiry into Airfield Activities at Auckland, Wellington and Christchurch International Airports*, August 2002, [http://www.med.govt.nz/templates/ContentTopicSummary\\_3315.aspx](http://www.med.govt.nz/templates/ContentTopicSummary_3315.aspx).

<sup>8</sup> Lianne Dalziel press statement 23 May 2003.

<sup>9</sup> PWC, *Air New Zealand Ltd Review of Returns of Auckland International Airport Ltd*, July 2007,

the analysis back to 1989, \$1 invested then in the newly-corporatised airport was worth (on my estimate) \$135 by 2007, a return of 36% p.a. compounding. The relevant WACC facing this monopoly airport operation was never out of the 7-9% range. The airport's monopolistic profiteering remains unregulated.

The asset valuation of the airport, resting on the assumption that price control would never materialize, was, nevertheless, subject to at least some distant regulatory risk. Cash from the Canadian pension fund would be free of that risk. Clearly that looked like a good deal for the airport owners. The Government's eventual decision to stop the sale was (apparently) not motivated by the history of deregulatory responsibility, but it had the effect of slowing the rot at least a little bit.

Redistribution in pursuit of social justice, and the prevention of redistribution in the opposite direction, is one fundamental component of good legislation and good government. Justice is not easily quantifiable, so it is not generally reasonable to demand (as in the proposed Bill section 7(j)) that officials and ministers must certify (subject to court scrutiny on appeal) the legislation will "produce benefits that outweigh the costs", if by this we are to understand that a formal cost-benefit analysis is being proposed. (If not, then the certification is redundant red tape for purely tokenistic purposes.).

### **Income Distribution and Cost-Benefit**

Transfers of wealth or income have obvious implications for social welfare. The Task Force's ostensible position is that it wishes "to ensure a hard look is taken at any legislation which takes property from one person (or a small group of persons) to benefit another groups of individuals" (Report p.47 paragraph 4.62). But the fact is that cost-benefit analysis and neoclassical economic theory 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. Let me spend a few minutes on each.

### *Redistribution and Weighting Schemes*

“Pareto gains” are changes which produce no losers and at least some winners. Very few policies in the real world meet this test.

For evaluating the great raft of policies that have losers as well as winners, neoclassical mainstream economic theory offers only the very restricted Hicks-Kaldor test for a potential pareto gain – that the winners could in principle compensate the losers and still come out ahead. That is not a necessary condition for a policy to be a good one. It is dicey even as a sufficient condition for good policy unless the problem of weighting different individuals’ interests has first been resolved.

In any cost-benefit assessment, to reach any clear balance of costs and benefits one must start with some prior view about the weighting to be attached to the interests of the losers as compared with those of the winners. Suppose a government has been elected with a clear mandate to raise the incomes of the poor by a programme of taxes on the rich to fund transfers to the poor. That programme will not result in a pareto gain unless the economic growth benefits from redistribution are so dramatic that even the rich end up better off – an outcome which the welfare state may well have generated in some cases, but not one that can be guaranteed in advance. So when the bold statesperson, having won election in a world subject to the Regulatory Responsibility Act, embarks on the required cost-benefit assessment, the first step must be to declare who matters more – the rich (who are to lose) or the poor (who are to win)?

Now if you think that a dollar taken from rich people represents a cost exactly equal to the benefit gained from giving a dollar to the poor, you

would conclude that the policy has zero net benefit, and so you would not proceed. But then you could not honestly have stood for election on a redistributive programme. The manifesto on which the electorate voted will have already embodied the prior claim that a dollar transferred from rich to poor advances the national interest.

One cannot simultaneously insist upon the arbitrariness of any weighting scheme applied to income and wealth distribution, and then claim anything other than pure arbitrariness for the cost-benefit practitioners' practical rule of thumb that "a dollar is a dollar" – that is, that all groups' welfare is to be weighted equally<sup>10</sup>. It is true that this is a very common opinion amongst mainstream economists, especially those of neoconservative persuasion, and it is one vigorously supported by the spokespersons of the rich. But it lacks any solid foundation in economic theory, let alone in the theory of justice. It is entirely an *ad hoc* device imported into public discourse by economists who actually have nothing to say at all about the question on the basis of pure theory.

The rule of thumb that "a dollar is a dollar" is vulnerable to two familiar criticisms: first that (as already noted) it is no less arbitrary than any other weighting scheme, and second, that if economists are unable themselves to offer any conclusive criterion for comparing gains and losses for different groups, their appropriate course of action is to respect whatever weighting scheme emerges from the political process<sup>11</sup>. "Efficiency" would then be not an end in itself, but simply a matter of finding the most effective means to socially-defined ends.

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<sup>10</sup> This practice became enshrined in cost-benefit manuals on the basis of arguments advanced by Arnold Harberger in the early 1970s; see Arnold Harberger, "Three Basic Postulates for Applied Welfare Economics: An Interpretive Essay", *Journal of Economic Literature* 9(3): 785-797, September 1971. Harberger made clear that he was well aware that his proposed rule of thumb required setting-aside crucial issues of income distribution and weighting of different individuals' welfare. See quotes later in this paper.

<sup>11</sup> This has been the position adopted by conservative mainstream economists addressing the distributional question in the past; progressive economists have found new, non-utilitarian arguments for advancing the interests of the poor against the rich. Amartya Sen has been a leader in this area.

If we compare the Task Force’s six principles with Rawls’ three basic principles of justice we can immediately spot where the big gap lies. The Task Force has no “broadly accepted principle of good legislation” that makes the legislator responsible for securing the system of justice upon which social cooperation itself ultimately rests. This is a rather large conceptual gap, which the Task Force might have been wise at least to acknowledge.

According to Rawls’ social-contract theory, individuals in an “original position” behind a “veil of ignorance” and entering into a hypothetical social contract would converge on three essential principles of a just society, which in turn would lead them to the appropriate institutional set-up, which in turn would be expected to embody the key principles which ought to guide legislators and regulators in going about their business.

Rawls’ statement of the “principles of justice” is as follows<sup>12</sup>:

- “(a) Each person has the same infeasible 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)”.

That last one is the crunch point. To a Rawlsian, inequalities that do not satisfy the maximin requirement must be eliminated before a society can be judged to be a just society – and in Rawls’ view, if a society is unjust by these criteria, then social cooperation itself is not ultimately sustainable. (Nozick, even in his far more minimalist frame of reference, similarly argues that a social contract that includes restraint on the untrammelled

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<sup>12</sup> John Rawls, *Justice as Fairness: A Restatement* (Harvard University Press 2001) pp.42-43

exercise of property rights is necessary to sustain society's escape from "anarchy".)<sup>13</sup>

Rawls' approach did not emerge simply from an exercise in pure logic. It embodied a recognition of the historical fact of the twentieth-century welfare state. The essence of the welfare state is that some redistribution of income and wealth is necessary to hold capitalism within the boundaries of justice. Without both redistribution and regulation, capitalism has inherent tendencies to stray outside those boundaries, and when it does so it places in jeopardy the entire project of social cooperation.

Lest you think that I am resting my case only on Rawls, I should point out that eminent economists from the outset have been concerned with questions of justice.

Here's Adam Smith:

**"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.

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<sup>13</sup> Robert Nozick, *Anarchy, State and Utopia* (Oxford, Basil Blackwell, 1986), pp.ix, 10-11, 178-180.

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.

As Viner notes<sup>14</sup>,

[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.**

Rosenberg concurs<sup>15</sup>:

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.

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Because the history of economic thought is not widely taught or read these days, the point I am making here may not be immediately recognized, but it was one of the most fundamental areas of debate within neoclassical welfare economics in the mid-twentieth century. I return to this shortly, after dealing with non-quantifiables.

<sup>14</sup> Jacob Viner, “Adam Smith and Laissez-Faire”, *Journal of Political Economy* 35(2): April 1927, pp.231-232. Emphasis added.

<sup>15</sup> Nathan Rosenberg, “Some Institutional Aspects of the *Wealth of Nations*”, *Journal of Political Economy* 68(6): 557-570, December 1960, p.560. Emphasis added.

*Non-quantifiabiles*

Consider how one might demonstrate that Fair Trading legislation, or the maintenance of a defence force, or the Road Code, have “benefits that outweigh the costs”, other than by the exercise of reasonable and informed judgment on the part of the decision-maker. The notion that properly formed judgment on matters that are unquantifiable ought to be subject to relitigation before the courts is simply a contradiction. If the policymaker has the role of making those judgments, then that is where the final word lies. If the courts have that role, then we can save ourselves the expense of keeping policymakers. At the end of the day someone somewhere has to make a judgment on the unquantifiabiles before cost-benefit analysis can be any use at all. The Task Force, it seems to me, wants to shift pretty much the whole job to the courts.

My quibble here is with any requirement that benefits be explicitly weighed against costs in terms of some common metric prior to legislation going before Parliament, or regulations being gazetted. Cost analysis on its own is a different matter, and some passages in the Task Force Report seem to reflect a recognition of this – for example, paragraph 4.84. It is obviously sensible to get as good an estimate as possible of the costs of any policy, and to seek to minimize the cost of implementing any given policy judgment. But that is a long way from the TaskForce’s apparent suggestion that benefit-cost assessment can precede key policy decisions. In this connection I am in agreement with the lawyer M.H. Moore<sup>16</sup>:

[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,

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<sup>16</sup> Moore, M.H., “Public Values in an Era of Privatization - Introduction”, *Harvard Law Review* 116(5): 1212-1228, March 2003, p.1220.

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.”

The existence of unquantifiables - public goods such as trust, goodwill, and sanctity of contracts - is fundamental to the successful operation of markets and societies. But it cannot be quantitatively shown that the Fair Trading Act or the Consumer Guarantees Act outweigh their costs - the passing of such laws requires policymakers to reach the prior judgment that protection of the general public from predation by unprincipled businesspeople is a good thing. The same applies to the courts themselves, which are paid for by society on the basis that the rule of law is worth having for its own sake.

The existence of unquantifiables is sufficient to rule out cost benefit analysis as a universal “principle of good legislation”. Whether or not cost-benefit is helpful to good policymaking in any particular case is a matter of contingent circumstances, not constitutional principle. Cost-benefit analysts and economists have to renounce any wish to carry their analysis beyond the tightly-constrained limits of what their discipline can actually do, and to accept as legitimate the judgement calls of those elected to make judgment calls.

### **Some history of economic thought**

I want now to fill in some of the background to the neoconservative idea that wealth transfers are in general welfare-neutral, so that uncompensated takings have no effects other than infringement of the rights of property owners. In standard cost-benefit it is usually taken for granted that there have already taken place any (uncompensated) transfers of wealth and/or income that may have been required to ensure that the requirements of justice and equity have been met. Only under this assumption can it be legitimate to array monetary costs and benefits without regard to the distributive consequences of the proposed measure. Only by this device has it been possible for mainstream economics to wash its hands of the messy business of adjudicating distributional consequences when there are losers as well and winners.

In New Zealand this was formalized in the so-called “public benefit test” used by the Commerce Commission in its consideration of price-control and mergers<sup>17</sup>. That test notoriously asserted that transfers from one person to another within New Zealand have no welfare implications and so can be ignored, leaving the Commission free to think only about “efficiency” – a proposition built into the Commerce Commission’s cost-benefit guidelines<sup>18</sup>:

[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).**”

Originally, utilitarian philosophers believed in the idea that welfare could be calculated, aggregated, and compared across individuals. In the hands of Pigou and Marshall this proposition, combined with the principle of diminishing marginal utility of income, pointed to a general welfare principle that equality of income and wealth must be optimal unless demonstrated to be otherwise. Rawls later formalised this in his diagram illustrating the maximin principle<sup>19</sup>. The welfare state rests upon this basic intuitive understanding that as a default, equality beats inequality, and equalizing redistribution tends to improve society.

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The great intellectual achievement of the ordinalist economists of the 1930s and 1940s, led by Robbins and Hicks, was to persuade economists that their discipline could in principle say nothing about this – which meant that economic theory could no longer be brought to bear in support of the welfare state. Fundamental to this was the notion that interpersonal comparisons of utility are impossible, from which it followed that no cost-

<sup>17</sup> Geoff Bertram, “What’s Wrong with New Zealand’s Public Benefits Test?”, *New Zealand Economic Papers* 38(2): 265-277, December 2004.

<sup>18</sup> Commerce Commission, *Guidelines to the Analysis of Public Benefits and Detriments, October 1994 (revised December 1997)*, Wellington.

<sup>19</sup> Rawls (2001) p.62 Figure 1.

benefit analysis could ever prove that taking a dollar from a rich person and giving it to a poor person is welfare-improving, unless some special weight could be shown to be appropriate for the interests of some individuals relative to others – precisely what the “impossibility of interpersonal comparisons of utility” ruled out for utilitarian economics. Cost-benefit was thus eliminated, at the outset, from being able to resolve the most fundamental policy issues facing the legislator.

The original welfare economics originated in utilitarianism, which proposed that it should be feasible to measure and add up the “utility” of all the individuals in society, and arrange policy in pursuit of “the greatest happiness of the greatest number”. In a hypothetical world in which resource allocation was to be guided by the quest for maximum utility, wealth and income would be distributed in such a way as to create the maximum attainable utility.

Neoclassical economics in the 1870s developed the principle of the diminishing margin – marginal product, marginal cost, and of course marginal utility. As each individual’s income rises, so does their utility – but subject to diminishing marginal utility, so that the last dollar received gives less additional utility than its predecessors. This made (and makes) perfect sense for each individual in isolation, but it presents a big problem when we aggregate individuals into a society. If indeed utility can be measured and added up, and if the principle of diminishing marginal utility holds, then unless individuals are very different from one another, the maximizing (optimal) distribution of income and wealth must be complete equality. Neoclassical economics thus slid, by the sheer force of its own internal logic as developed by Pigou, into a radically egalitarian position, which subsequently became the basis for the welfare state policies of mid-century.

While for some economists this outcome was pleasing, to others it was not. To many it seemed obvious that there had to be economic benefits from some inequality in society, which meant that there was something wrong

with either the logic or the premises. To many others for whom the defence of property and wealth was congenial – either because they had these things themselves, or because they sympathized with or were paid by those who had them – there was a strong incentive to undertake the same quest.

Lionel Robbins found the solution in 1931<sup>20</sup>: it is not in fact possible to compare the utilities of individuals one with another and hence to compute a utilitarian social welfare function. John Hicks tightened up the analysis in 1934: utility itself cannot be measured at all, so that economics is left only with ordinal, non-utilitarian analysis. It then took two decades more of development in pure theory before Ian Little and J deV Graaff in the 1950s brought out the logical implication: neoclassical welfare economics had nothing at all to say *a priori* about the optimal distribution of wealth and income. That meant that pure economic theory could not assist the policymaker in decisions that involved losers as well as winners (that is, changes that were not pareto gains) – though applied economists could help quantify the consequences of such policy choices once made.

Policies that made the distribution of wealth and/or income more unequal could still be judged favourably provided that there were no losers (a similar idea to Rawls' "difference principle" under which justice requires the policymaker to aim to maximize the position of the worst-off). Policies that made the income or wealth distribution more equal could be judged favourably provided that they operated entirely by raising the incomes of the poor without reducing those of the rich.

But policies that improved the lot of the poor by taxing the rich lay outside the domain of neoclassical theory: the economist must stand aside silent as the policymaker exercises political judgement, because political judgement (provided it is exercised responsibly and subject to democratic electoral

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<sup>20</sup> Lionel Robbins, *An Essay on The Nature and Significance of Economic Science*, London: Allen and Unwin, 1931; Roger E. Backhouse, "Robbins and Welfare Economics: A Reappraisal", in *Lionel Robbins' Essay on The Nature and Significance of Economic Science 75th Anniversary Conference Proceedings*, ed. Frank Cowerl and Amos Witztum, London, STICERD, 2006, <http://sticerd.lse.ac.uk/textonly/events/special/lionelrobbins/ConferenceProceedings.pdf>, pp.86-98.

choice and due process of law) is the only basis on which these decisions can be made, in the absence of anything helpful from economists.

Taken on its own, this abdication of neoclassical economics from having anything to say about the really serious policy issues (those where no pareto improvement can be demonstrated because there are losers as well as winners within the society to which the policy applies) is harmless, because it leaves policymakers free to exercise their judgment without fear of being contradicted by “economic theory”. Properly applied, the insights of neoclassical theory immediately rule out any notion of requiring legislation to pass in advance a cost-benefit test, because there is no conclusive cost-benefit test for any policy outside the restricted set of fully-pareto-improving changes.

Alas, and 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 had shifted wealth and power in favour of the poor and the weak, on the basis of an explicit political judgment that this was a good thing to do, and nothing in neoclassical economic theory demonstrated or demonstrates the contrary, however much conservative ideologues might 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.

Neoclassical economists re-entered serious policy debate by adopting as basic principles a couple of highly contentious, and generally false, but useful propositions. First was the idea that “a dollar is a dollar” – in other words, that no welfare weight whatever can be assigned to the transfer of a dollar from one person to another. Harberger (a Chicago man to the core) introduced this to the cost-benefit manuals originally just as a way of making progress towards quantifying the effects of policy changes.

Harberger's proposal was that<sup>21</sup> "when evaluating the net benefits or costs of a given action ... the costs and benefits accruing to each member of the relevant group (e.g. a nation) should normally be added without regard to the individual(s) to whom they accrue." This approach implicitly assumes (i) that the social welfare function is utilitarian, in the sense that interpersonal comparisons are possible and each individual's dollar is worth the same as each other individual's dollar; and (ii) that the marginal utility of income is constant so that all dollars are worth the same to each individual. It directly violates, in other words, both Robbins structures against interpersonal comparisons and the principle of diminishing marginal utility on which most neoclassical theory rests.

The sole legitimate argument for this procedure is that it is operationally convenient – something that is clear in Harberger's discussion<sup>22</sup>:

"[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.**

...

"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."

...

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

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<sup>21</sup> Arnold Harberger, "Three Basic Postulates for Applied Welfare Economics: An Interpretive Essay", *Journal of Economic Literature* 9(3): 785-797, September 1971, p.785.

<sup>22</sup> *Ibid.* p.785-787, emphasis added.

they represent. Giving equal weight to all dollars of income is mathematically the simplest rule.”

I cannot emphasize too strongly that the widely-canvassed notion that “transfers are a wash” has no foundation in post-1931 mainstream neoclassical economic theory. It was originally an *ad hoc* device to rescue cost-benefit analysis from irrelevance. It became elevated over the subsequent three decades into an article of faith among neoconservative commentators, and from there it was pressed upon officials, parliamentarians and ministers by a growing army of well-funded business lobbyists.

While acknowledging that their economics could not adjudicate any policy involving losers as well as winners, practitioners justified the policy relevance of their numerical results by adopting the assumption that whatever distribution of income and wealth actually prevailed must be optimal – or if it were not optimal, policymakers could be relied upon to bring about change to the optimal distribution through separate policies.

That meant that the ability of cost-benefit analysts to proceed directly to policy conclusions without reference to distributional consequences (and commonly with little concern to get seriously into shadow-pricing) rested (and rests) on the prior proposition that 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, in which case one could not proceed to analyse policies on the basis that a dollar is a dollar, or that transfers at the margin are inherently welfare-neutral.

This proposition is, I suggest in passing, instantly fatal for some cherished neoliberal stories about the state - particularly “public choice” theory which assumes that politicians are inherently self-interested and officials are inherently unable to formulate policy to improve on market outcomes.

Let me run through quickly a few key passages from leading mainstream economists who have dealt with these issues:

Coase<sup>23</sup>:

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.**

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Williamson<sup>24</sup>:

“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....**

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“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

“[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.**

## Transcendental Institutionalism and its Critics

Rawls and Nozick, probably the two best-known twentieth century philosophers working with a contractarian approach to the theory of justice

<sup>23</sup> R.H. Coase, “The Marginal Cost Controversy”, *Economica*, New Series, 13(51): 169-182, August 1946, p.172, emphasis added.

<sup>24</sup> Oliver E. Williamson, “Economies as an Antitrust Defense: The Welfare Tradeoffs”, *The American Economic Review*, 58(1): 18-36,. March 1968, pp.28-29.

and the foundations of political constitutions, have been jointly labeled “transcendental institutionalists” by Amartya Sen<sup>25</sup>. Sen’s complaint, directed specifically at Rawls, is that the best can be the enemy of the good. Rawls, he says, lays out the requirements for a perfect scheme of social cooperation on the basis of principles of justice derived from an original-position exercise, but fails to address the everyday problems of relative justice that confront policymakers in a real second- or third-best world which departs substantially from the Rawlsian ideal.

Two of Sen’s points seem to me especially telling. The first is that Rawls, like most contractarians, thinks that the solution he has identified to the problem of choosing an ideal set of institutions behind a veil of ignorance is unique, when in fact the individuals gathering behind the veil will bring with them a wide range of judgments about critical issues, so that unanimous agreement on institutional design may not be feasible; and if feasible, the outcome of the deliberations will not be the only possible outcome – simply the outcome that arises from the collective judgment of a particular set of individuals. (Rawls, in technicians’ language, satisfies the existence test but fails to provide a uniqueness proof.)

Sen’s second point, about which I want to say more here, involves stability: even 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.

Here is how Rawls himself put the matter<sup>26</sup>:

[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

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<sup>25</sup> Amartya Sen, *The Idea of Justice*, Harvard University 2009.

<sup>26</sup> Rawls (2001) pp.6-7.

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."

As Sen observes<sup>27</sup>,

[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)?

... [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

Rawls' presumption, Sen says<sup>28</sup>, 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." This is deeply problematic because<sup>29</sup>

Demanding more from behaviour today than could be expected to be fulfilled would not be a good way of advancing the cause of justice.

Notwithstanding my earlier comment that the Task Force lacks apparent concern with any theory of justice, I think that the proposed Regulatory Responsibility Bill is recognizable as an exercise in the sort of transcendental institutionalism that worries Sen. It is a commonplace for economists to observe that the mere act of setting up a regulatory provision is apt to trigger a set of behavioural responses as individuals seek to evade or subvert the regulation in pursuit of their own interests.

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<sup>27</sup> Sen (2009) p.68-69

<sup>28</sup> Ibid. p.79.

<sup>29</sup> Ibid. p.81.

In that spirit I anticipate that if the Regulatory Responsibility Bill is passed, a range of behaviours will be triggered in response, as policymakers and officials try to get around the restrictive and often counter-intuitive requirements of the alleged “principles of good legislation”, and as well-funded business interests use the courts to obstruct reasonable attempts to regulate their profit-taking.

To elicit ‘reasonable’ (in the TaskForce’s proposed contractarian world) behaviour from policymakers, the principles would either have to run in an incentive-compatible way alongside the wishes of policymakers and their own views of what is reasonable, or would have to succeed in changing the political climate rather radically – for example, by barring from office anyone who believes in uncompensated transfers from rich to poor as good policy. (One obviously cannot rule that out altogether!)

It does seem to me that many of the neoliberal measures of the past two decades in New Zealand have fallen foul of the problem that rational behaviour is often ‘unreasonable’ in the Rawls sense, and that ‘reasonable’ behaviour in the Rawls sense is often not rational. Brian Easton and Bill Rosenberg have provided examples of how disappointed a genuinely consistent and principle neoliberal ought to be with the great deregulatory experiment since 1984. I offer two more quick examples:

- The Fiscal Responsibility Act, which sought to force Ministers of Finance to fully account to Parliament for all transactions that might affect present and future taxpayers, and to explain the full consequences of budgetary measures, has left us with a policy environment in which politically-contentious transactions have simply been shifted off the Crown balance sheet, and fiscal policy has drifted towards increasing reliance on so-called SOE profits and asset revaluations, all accounted for by separate entities over which Ministers ostentatiously pretend to have little or no control and for whose behaviour they evade accountability. The ETS, I have

argued in a joint paper with Simon Terry<sup>30</sup>, is another exercise in creating off-balance-sheet vehicles to evade political accountability.

- The regime of “light handed regulation” applied at the end of the 1980s and in the early 1990s to utility operators with market power – electricity, gas, telecommunications – was promoted on the basis of a transcendental-institutionalist set of propositions about
  - (i) market participants behaving in a socially-responsible (“reasonable”?) manner,
  - (ii) information disclosure providing customers with the information that they could use to countervail price gouging and other abuses of market power, and
  - (iii) transparency incentivising good behaviour rather than simply providing a focal point for industry collusion.

As I have outlined elsewhere<sup>31</sup>, those expectations (assuming they were genuinely held by the policymakers at the time) quickly fell foul of actual behaviour by company managements driven by profit and the quest for untaxed capital gains, in an environment where government took no effective steps to reward reasonableness or penalize rational but unreasonable (in the Rawlsian sense) action. The outcome was the failure of what looked at one time a potentially fruitful exercise in achieving social cooperation in pursuit of both efficiency and justice. We ended up with neither – unless you happen to be one of those who regard price-gouging and uncompensated asset revaluations as hallmarks of “efficiency”. This was an area where effective regulation could have been less cumbersome, intrusive and wasteful of everyone’s time and money, if it had been designed tightly, enforced effectively, and if reasonable behaviour had prevailed over rational.

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<sup>30</sup> Geoff Bertram and Simon Terry, *The Carbon Challenge: Response, Responsibility, and the Emissions Trading Scheme*, Wellington, Sustainability Council, 2008, <http://www.sustainabilitynz.org/docs/TheCarbonChallenge.pdf>.

<sup>31</sup> “Light-Handed Disciplines on the Market Power of Network Owners: New Zealand’s Pipeline Access Code and Gas Industry Information Disclosure Regulations”, *Victoria Economic Commentaries* 16(1):101-27, July 1999.