

Ideology, Economics and Public Policy

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I am honoured to have this opportunity to address you on the occasion of the 50th anniversary and Annual General Meeting of the New Zealand Institute of Economic Affairs. The Institute has had a distinguished and significant role in economic research and debate in New Zealand. Its departing director, Brent Layton, has made a particularly important contribution in this regard and in challenging times for our economy.

This is a suitable occasion to reflect on the state of applied economics, and I will do so in the context of public policy.

My thesis is that there has been some diminution of the place of economics in the development of public policy. I will try to explain why I think this has happened and why it is a probable contributing cause of some poorly designed state institutions that are undermining the quest for productivity improvement across the economy.

Ideology

There has been, to an extent that I would not want to exaggerate but is clearly in evidence, a downgrading of the place of economic analysis in at least some important areas of public policy, both philosophically and practically.

Philosophically, there has been a degree of rejection of the economic method of analysis – not as extreme a rejection as in the period from 1981-84 but nonetheless apparent. What are some of the reasons for this?

In the realm of ideology, the present government includes powerful individuals who are out of tune with the underlying philosophical liberalism of much economic methodology.

Economics' primary mode of analysis is to examine how people and firms exercise free choice in the context of the incentives they face. It is therefore concerned to examine what is happening in markets.

For people on the left – at least the old left – the market is a site of chaos and economists are suspected of promoting it and tolerating unacceptable behaviours and outcomes. Leftists – at least of the statist variety – see the market as a human creation that can and should be supplanted by a superior form of economic organisation overseen by the state.

However, economists from Adam Smith onwards have accepted that market participants sometimes behave badly. They may create and take advantage of situations that cause resources to be used inefficiently, abuse their power and act unethically. Adam Smith himself is said to have preferred his other book

The Theory of Moral Sentiments to The Wealth of Nations. This is essentially about good individual conduct in a free society.

But while the economic method has always allowed room for scepticism about markets, it also allows for scepticism about the benefits of state control over markets. Its analytical methods seek to evaluate the net benefits of any adjustment to the role of the state in markets by weighing up the risks of government failure alongside the risks of market failure. While economists as individuals have their philosophical and political preferences – and are themselves subject to incentives – the examination of the role of the state in promoting and destroying wealth is core business for economists.

The present government and leftists generally begin with a preference for state action over the market and a rejection of the economic method and its archetypal solutions. This is partly a matter of ethical disapproval of behaviour that economists are dispassionate about. Let me illustrate this point with examples of what I mean.

- Consider first student loan subsidies. A minister seemed surprised that loans were used for purposes he had not intended, even though the incentives in the policy made this a certainty.
- When she was minister of state services, Margaret Wilson, in a speech to the Legal Research Foundation, rejected the idea of performance measurement and performance incentives introduced by the state sector reforms in favour of reliance on the spirit of 'public service'. This spirit is of course essential for good government, but the incentives in the governance frameworks around state organisations shape behaviour in important ways and have to be taken into account when thinking about state sector performance improvement.
- This ideology also emerges in demonising some forms of policy change so that they are off limits and adult conversation about them is impossible. Examples are toll roads and privatisation – or even nationalisation. Where is the debate in these areas?
- There is unsubstantiated and endless criticisms of the entire programme of earlier privatisations. According to the urban myths, all assets privatised were sold too cheaply – even though tough competitive processes were used to get the best deal for taxpayers. But it is apparently acceptable to buy back tired rolling stock at a price that sent the parent company's share price up 5 percent – an indication of apparent over-payment.
- We have witnessed the diminished position of the Treasury and the transfer of some of its functions to organisations that are less concerned with economic analysis and more in tune with the central planning and coordination methods that have replaced it.

As a consequence of these ideological preferences, a decentralised economic framework has given ground to one of central political control in which ministers take hands-on charge of state activities that oversee aspects of the private sector or of state sector service delivery. They act as discretionary managers in effect and establish subordinate organisations to do activities called planning and coordination in a so-called 'whole of government' framework. These operate as a kind of secretariat to the minister. Some of the characteristics of this paradigm are:

- political appointments to governance and advisory positions with attention to political loyalties
- an increase in direct but non-transparent intervention by ministers into the governance and management of public organisations
- a belief in central coordination and direct control as the solution to problems rather than decentralised solutions
- a strong disbelief in the effectiveness of markets in allocating resources and managing risks and a bias against private sector provision of public services, consumer choice and competition in the provision of services funded by government. This is notwithstanding evidence such as that offered in Julian LeGrand's recent book, *The Other Invisible Hand*, that choice and competition favour those who are disadvantaged and powerless
- a preference for heavy-handed regulation and public ownership over competition and light-handed regulation to correct undesirable behaviours and outcomes in markets, and
- utopian beliefs about the state, and therefore an inclination to expand it. (Surely Marxists and liberals find common cause in not seeing their visions of a good society compromised by excessive bureaucracy?)

Adherents to this paradigm have won three elections in a row and it could become a permanent part of our policy fabric – although its influence, like that of economics, will ebb and flow over time.

Some shrinking of the place of economics in some policy areas was inevitable and convenient for the agenda of the present government, which made it clear from the beginning that it was in the business of redistribution. A government that wants to redistribute a lot of national wealth is not going to welcome advice from economists about incentive effects, deadweight losses and administrative costs. Also economics does not have much to say about net welfare effects when policies create winners and losers. Ideology and political calculation have more to say on the subject.

But I suggest that the triumph of this new – or, perhaps more accurately, recovered paradigm – has caused some collateral damage to economic

reasoning in policy circles. And, in at least a few significant areas of policy, this has exposed weaknesses that might have been avoided with better economic analysis and is constraining the range of options for increasing productivity and national wealth.

Before turning to some examples, I want to place these observations in the context of national objectives for increasing per capita incomes (expressed variously as catching up with Australia or the OECD average) by raising two insights about economic growth and productivity improvement.

First, recall Robert Solow's great insight that any economy's long-term growth rate is constrained by the rate at which it can accumulate and deploy new ideas that enable an economy to raise output faster than the inputs it uses.

Second, the high and sustained rates of growth that only 13 countries have experienced since World War II are partly about catch-up by adopting ideas from elsewhere. The more you catch up, the harder this gets as imitation can take you only so far. When you are a high-income developed country, annual growth of around 2.5 percent is the norm as you have to invent more of the new ideas yourself at the technological frontiers. The richer you are, the harder it gets.

The reports on economic development by the Treasury, the Ministry of Economic Development and Statistics New Zealand show that we are making heavy weather of this and the suite of papers on productivity released by the Treasury offer some insights as to why. The latter reflect a proposition that is well accepted in the international development literature: that the quality of institutions is a central explanation of the difference in growth rates between countries, as institutions provide the basis for many of the drivers of productivity improvement.

The importance of sound institutions to an economy that is already quite developed is that they support the transition from imitation to innovation. This is the only way up for a high-income country. The higher up the ladder of wealth you get the more your further progress depends on the quality of your institutions.

For the economist, of course, institutions are not schools, hospitals and prisons – although they can result in these. Institutions are rules and rights and processes and other things that shape the environment around economic actors. While competition in the private sector can be expected to cause innovation in institutions that drive out wealth-destroying institutions over time, in the public sector wealth-destroying institutions can persist indefinitely, as they do in the poor countries of the world.

And so it is the institutions created by the use of the coercive powers of the state that should be the focus of attention in seeking higher productivity.

I will now mention a few examples of case evidence to suggest that some

institutions created by our state are creating needless burdens on national productivity performance by contrast with better feasible designs.

Health

With various caveats about the data, a 2005 Treasury report released eventually under the Official Information Act concluded that there had been an average 2.6 percent per annum *decline* in hospital productivity in 2000 - 2003 (defined as the gap between the growth rates in real expenditure and measured outputs). This compares with an *increase* in productivity of 1.1 percent per annum over the previous three years. The main institutional change between these two periods was the abolition of the Health Funding Authority (HFA) and the creation of the District Health Boards (DHBs).

Unable to get further data on productivity, I and my colleagues obtained financial support from the New Zealand Business Roundtable to provide some assistance to an expert in data sources and analysis in the hospital sector to dig deeper into this. This research will be released shortly and what it will show is that the productivity problem did not stop in 2003. The measured outputs per employee in the hospital sector over five or six years have fallen, in addition to real prices going up. The price increases vary according to which deflator you use.

This is consistent with the evidence of large increases in spending at the same time as waiting lists, in Wellington at least, have included large numbers of people who have already qualified for surgery.

After nine years the question should be asked as to whether the DHB model is failing, as it appears to be, in terms of productivity and perhaps other measures as well. This model came to town as New Zealand First policy in the first MMP government. Winston Peters as treasurer and Bill English as health minister eventually discarded the policy as having unmanageable fiscal risks, which today seems like a good call.

Of relevance to my topic here is the process by which the decision to have DHBs was considered. When the present government was elected HFA staff – who knew more than anyone about the practicalities of funding the public health system – were directed by the new board that they were not to give any advice on the matter and not to discuss it with Treasury. Remember, four Regional Health Authorities had been amalgamated because of overhead costs and because the technology and management of modern health purchasing had proved too demanding for four different organisations to invent for themselves.

There was never a chance that 21 DHBs would maintain the credibility, capability and discipline required of a smart health purchaser of complex hospital services – particularly one they owned. The predictable consequence has been that the boards have been topping up their hospitals with funds that

are not tied to explicit service delivery. This problem, known as the 'second chequebook', had taken years to get under control in the 1990s and has returned. Add to this the fact that the boards are given budgets to manage but the minister gets involved in settling pay disputes and you can see why some boards fell over; they could not stay within their population-based bulk funding. My recommendations for health would be to:

- restore central management and governance of the hospitals so that the mix of centralised and decentralised functions can be rebalanced for greater efficiency and quality of service
- if DHBs remain, focus them on comparative advantages in the areas of service planning, public health, monitoring and representation
- re-establish funding on a price, volume, and quality basis using national systems and data, and
- evaluate the large increase in administrative staff numbers in the Ministry of Health and the health sector more widely.

Electricity

Telecommunications and electricity are prime examples of the shift from light-handed back to heavy-handed industry-specific regulation. This shift comes straight from the current central planning paradigm but is overdue for some deep consideration as to whether it has promoted or undermined economic growth. In telecommunications, Bronwyn Howell's research suggests the latter.

In electricity, heavy-handed regulation is implemented through the Electricity Commission. The submission I prepared on behalf of many participants in the industry when the creation of the Electricity Commission was being considered showed that the Commission was programmed for failure. The design ignored well-accepted principles of institutional economics concerning governance, funding and management. It is the politicisation and coordination paradigm's archetype. The meltdown with Transpower was wired into the design.

We have spent 20 years reforming this industry and still don't have the answer. The core problem was always how to integrate generation and transmission and how to strike prices for both that reflected the opportunity costs of the resources each uses. A further problem was how to arrange the governance of state-owned participants. With regard to competition policy, general competition principles can apply with particular attention to the 'use of system' agreements that control access of generators to local lines.

There have been claims that the Electricity Commission which, to be fair, it strongly denies, has tried to influence the prices that generators bid into the market. When money is lost by the back-up generator, which the government levied the industry to build, its losses are levied on the industry. The regulator

is not sufficiently and formally independent and there is a lack of transparency in its statute about ministerial influences on it. This all adds uncertainty to investment decisions and has caused companies to increase the resources they devote to managing relationships with the government.

As in health, there were process problems in creating this Commission. Officials had told the industry privately that it was just a threat to get it to do what the government wanted by way of voluntary agreement, and that it would not be implemented. This takes us back to the days of the Economic Stabilisation Act and the Remuneration Act – the lessons about threats of interventions seem to have been forgotten.

My recommendations for electricity would be to:

- transfer out of the Electricity Commission activities for which it has no comparative advantage or adds no value. A review might show this to be:
 - transmission investment and maintenance
 - wholesale price formation
 - backup generation
- reframe Transpower in the nature of either a club of users or on more commercial lines, with a partial sell-down of shares
- re-establish industry governance and working groups of the kind that built the market originally with the authority to design and implement common rules and institutions:
 - pick away at the longstanding and difficult issues of transmission pricing one step at a time
 - encourage regulators to look out for industry fixes that are not in the public interest, using well-known criteria and policy
 - work to design more advanced instruments for risk management
- focus government intervention on issues of stability of supply and competition – eg use of systems agreements, and
- tidy up the issues of water rights.

Let me touch quickly on some other evidence that the state's role is misdirected in areas that would benefit from greater emphasis on productivity.

What are we to make of the contribution to national productivity of an extra number of public servants equal to the global employment of the World Bank, and the mounting informal evidence that there is significant pay leadership over private wage levels in the middle ranks?

What are we to make of the rush of patronage appointments to state bodies and the fact that powerful people with good political connections are accumulating multiple positions? Richard Norman's research into state-owned enterprise boards shows disturbing trends in this regard.

The growth in the size and cost of the state and the questions over quality and productivity in some areas mean the question must be asked: 'Is the state on balance building wealth-creating institutions?' I would like to have seen some insights into this question in the productivity research programme of officials.

My recommendations regarding economics and public policy are to:

- reinvest in capability for economic analysis as an important input for superior public policy. This is not to argue for hegemony for economics, rather that advice from that professional perspective should be received and considered alongside insights from other disciplines that can provide an integrated perspective across the policy silos that have been created
- review the appointment process, roles, capabilities, and accountabilities of official advisers. More needs to be done to ensure that if public servants are accorded the privilege of being employed as advisers with special access to ministers, there is a reciprocal obligation on them to produce high quality analysis to support that advice
- specifically in respect of economic advice, I would recommend:
 - reinvesting in Treasury
 - restoring the position of professional advisers in the cabinet decision processes
 - putting Treasury back into high-level regulatory policy from an economic development perspective. Incidentally, recent work by a parliamentary select committee on Rodney Hide's Regulatory Responsibility Bill is a good example of a sound process. MPs and ministers may not agree with everything in the bill but they have given it careful consideration and the process promises some consensus to address the regulatory overload.
 - rewriting the Public Finance Act to a best international benchmark standard for performance budgeting, monitoring and evaluation, and
 - embedding in statute Treasury's mandate and obligation to provide analysis and advice on the long-term economic interests of New Zealand and the provision of the tools and capability needed to do this.
- This has implications for fiscal policy and public management:

- forget about hiring freezes and the like and reinvest in the performance system so that it can be used to roll back or cut out low-value activities incrementally and continuously
 - strengthen the mandates and capability for monitoring and evaluation of all state sector activities and create a centre of focus for this activity
- approach the Australian government with a proposed mandate and governance structure to expand the role of its Productivity Commission to cover New Zealand
 - mandate evaluations of the coordinating institutions that have been established (such as the Electricity Commission and the Tertiary Education Commission) with a view to preserving only activities that are of proven value to the national interest, and
 - ensure that competition policy is focused on the net benefits of an intervention from the perspective of national economic welfare against real world counterfactuals – not idealised ones or value judgments about redistribution between producers and consumers.

With respect to transparency and official information:

- remove all protections from routine performance information
- ministries and others should present strategies for disclosure of performance information for review by relevant select committees and the central agencies
- Statistics New Zealand should be given increased powers to decide on what statistical series regarding state sector performance it publishes and to get the information it needs to do this.

On governance:

- review the agenda of quasi-constitutional issues that might, either in specific areas or perhaps more generally, address openly the clash between short-term political incentives and long-term wealth creation. The Reserve Bank Act and the Fiscal Responsibility Act were early and successful examples of this approach applied to monetary and fiscal policy. One distanced politicians from decision making and the other embedded requirements for thorough analysis and advice and principles of sound fiscal management
- complete the passage and implementation of the Regulatory Responsibility Bill

- set up an appointments commission which, like the State Services Commission, presents recommendations for appointments to state bodies on the basis of capability, and
- restore clarity and transparency around the role of ministers in relation to SOEs and Crown Entities.

My concluding thoughts are as follows:

1. Whether or not the deterioration in recent years in measured productivity growth relative to the underlying trend of improvement we saw in the 1990s is confirmed, public policy needs to stay seriously focused on the nexus of issues that explain productivity trends. There are strong theoretical and empirical reasons to believe that catching up gets much harder the closer you get to the frontier of innovation. We cannot afford the luxury of tolerating large inefficiencies in the sheltered sectors and the state sector in particular.
2. We do not need big new ideas – like swapping the current fashion for 'libertarian paternalism' for the intellectual corpse known as the 'third way' – but we need workmanlike application of world-class methods to our situation as it evolves.
3. The tension in democracy between efficiency and equity and between citizen rights and market freedoms is permanent. Great states resolve these tensions with levels of technical and political skill that are not in evidence here.
4. The arenas for much of this political tension are the institutions of the state like the ones I mentioned. If we want a successful economy then we must have outstanding state institutions. We can do much better than what we have now.
5. For 50 years the NZIER has been a great contributor to research, debate and public policy. May it flourish, may it continue to seek to broaden and refresh the national conversation about economic policy; and may it make its contribution to higher living standards through joining the painstaking work of reviewing, renovating, building or demolishing policy frameworks and the institutional arrangements that support them.

