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Deregulatory Irresponsibility:
Takings, Transfers and Transcendental Institutionalism

Introduction

The taskforce on the Regulatory Responsibility Bill has put forward what it considers to be six 'broadly accepted principles of good legislation'. I shall argue, from the standpoint of an economist, against this description. In their present form, several of the principles have extreme implications for policy; and some 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.

A central deficiency is the absence of a satisfactory underlying theory of justice and politics to provide a reference point for the proper function of government and legislation, and recognition that issues of fairness are central to real-world policy making. This is not to say that the taskforce ought itself to have engaged in moral philosophy, but it certainly ought to have shown more awareness of the ethical dilemmas with which legislators must grapple, dilemmas requiring political judgments for which economic theory and cost-benefit cast no light. One interpretation that could be placed on the taskforce's selection of 'principles' is that it seeks to privilege one group's views of what is 'right' over other, competing views. In democratic politics a range of competing views is legitimate, and there are good grounds for resisting any rewriting of the rules of the political process to give primacy, or advantage, to some of those views. The proposed bill looks like an attempt to do that.

The taskforce report 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 report starts from a prior hostility to government *per se*, a desire to rein in the extent of state intervention in economic and social matters,[1] and an unqualified adoption of the views of strict property-rights adherents. Consequently, the six 'principles' 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[2] 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.[3] Players with deep enough pockets to afford high-powered lawyers would be able to use the measure to obstruct government attempts to regulate

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their activities, and this is the core of my concern with the bill and the report.

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.

I confine my comments in this article to elements of just two of the principles: the proposition that any 'taking or impairment 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.[4] 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.

The article has a second theme, regarding the proper application of cost-benefit analysis. Far too great a burden is placed on the notion that cost-benefit analysis somehow offers a means of resolving issues involving deep policy choices.[5] 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' is not a valid test for distinguishing good policy from bad.

Takings, impairment and compensation

Consider the issue of transfers of income and wealth within the community. 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. The taskforce contemplates no situation where 'full compensation' might not be paid. Compare this with the wording of the United States' Fifth Amendment, which requires only 'just compensation' and includes a 'due process' qualifier: '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.

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The 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 because it was an obstacle to economic progress and because it embodied significant elements of injustice.

The Fifth Amendment to the US Constitution was adopted in 1789, at a time when slavery was considered fully compatible with Enlightenment thinking and the Magna Carta. It was more than half a century before slavery was abolished, in one of the more spectacular uncompensated takings of the 19th 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. Adam Smith's list of the three duties of the sovereign included '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' (*Wealth of Nations*, book 4, chapter 9). This included policy measures that would encroach on the interests of property and wealth. Smith, as Viner noted,

> saw that self-interest and competition were sometimes treacherous to the public interest they were supposed to serve, and … 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. (Viner, 1927, pp.231-2; see also Rosenberg, 1960, p.560)

Right-wing 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 achieved by uncompensated taking from the rich to give to the poor. 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:

> [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. (Evans and Quigley, 2009, p.33)

The suggested 'discipline' would 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 as measured by GDP).

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 20th century's greatest historical achievements, you will be worried about 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 include 'promotion of the welfare state' in their list of 'Government interventions that result in uncompensated takings of property rights'. They acknowledge 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' (Evans and Quigley, 2009, pp.1, 33). This indeed is the argument I am making here. They then go on, in the passage I quoted first, to treat the payment of actual financial compensation as defining the outer limit of good legislation. But the ability to pay financial compensation to those who lose is neither a necessary nor a sufficient condition for good policy. The effect of the Evans–Quigley test is not to control the quality of legislation, but to rule out *as a matter of principle* any legislation with redistributive effects.

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Redistribution in pursuit of social justice, and the prevention of redistribution in the opposite direction, is a 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, that officials and ministers must certify (subject to court scrutiny on appeal) that legislation will 'produce benefits that outweigh the costs' (section 7(j)), 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. But cost-benefit analysis and neoclassical economic theory cannot illuminate those implications 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 intelligible equivalent evaluation of things that are inherently unquantifiable. To date mainstream economic theory has come up with no satisfactory ('broadly accepted') way of doing either.

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 neither a necessary nor a sufficient condition for a policy to be a good one.

To reach any clear balance of costs and benefits of a policy 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 probably not result in a pareto gain. 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 (explicitly or implicitly) the prior judgment that a dollar transferred from rich to poor advances the national interest.

In standard cost-benefit analysis it is usually assumed 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 – 'a dollar is a dollar', which implies that all groups' welfares are weighted equally. The notion that transfers are value-neutral is sometimes elevated to dogma by conservative economists, is vigorously supported by the spokespersons of the rich, and has been central to some recent New Zealand regulatory decisions (notably the Commerce Commission's notorious 'public benefit test': see Bertram, 2004), but it lacks any foundation in economic theory, let alone in any theory of justice. It is entirely an arbitrary *ad hoc* device imported into public discourse by economists who in fact have nothing to say, professionally, about how to adjudicate the distributional consequences when there are losers as well as winners (Coase, 1946, p.172; Williamson, 1968, pp.28-9).

Since 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. 'Efficiency' would then be not an end in itself, but simply a matter of finding the most effective means to socially-defined ends.

Those ends would include a conception of social justice. Rawls, for example, includes amongst his 'principles of justice' the idea that 'social and economic inequalities … are to be to the greatest benefit of the least-advantaged members of society (the difference principle)' (Rawls, 2001, pp.42-3). To a Rawlsian, inequalities that do not satisfy this requirement must be eliminated before a society can be judged to be a just society – and in Rawls' view, if a society is unjust, then social co-operation itself is not ultimately sustainable. Nozick, even in his far more minimalist frame of reference, similarly argues that restraint on the untrammelled exercise of property rights is necessary as part of a social contract to sustain society's escape from 'anarchy' (Nozick, 1986, pp.ix, 10-11, 178-80).

Rawls' approach did not emerge simply from an exercise in pure logic. It embodied recognition of the historical fact of the 20th-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 co-operation.

Because the history of economic thought is not widely taught or read these days, the point I am making here may not be immediately recognised, but it was one of the most fundamental areas of debate within neoclassical welfare economics in the mid-20th century. I return to this shortly.

The taskforce, it seems to me, wants to shift much of the job to the courts. Where 'merits' are a matter of political judgment, 'appeal on the merits' will inescapably impose a shift of this kind.

Non-quantifiables

The existence of unquantifiables – for example, 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 benefits of the Fair Trading Act or the Consumer Guarantees Act outweigh their costs: the passing of such laws requires policy makers 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 policy making in any particular case is a matter of contingent circumstance, 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 reasonable and informed judgment calls of those elected to make judgment calls. Elected policy makers do not have to answer to economists (nor to the courts) for their value judgments on matters involving the public interest.

The notion that properly formed judgments by elected law makers on matters that are unquantifiable ought to be subject to relitigation before the courts is a contradiction. If the policy maker 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 policy makers. At the end of the day somebody somewhere has to make a judgment on the unquantifiables before cost-benefit analysis can be any use at all (see Moore, 2003, p.1220). The taskforce, it seems to me, wants to shift much of the job to the courts. Where 'merits' are a matter of political judgment, 'appeal on the merits' will inescapably impose a shift of this kind.

It is obviously sensible to get as good an estimate as possible of the costs of any policy, and to seek to minimise the cost of implementing any given policy judgment. But that is a long way from any suggestion that benefit-cost assessment as understood by economists can always precede key policy decisions.

Some history of economic thought

Utilitarian philosophers such as Bentham and Mill believed in the idea that welfare could be calculated, aggregated and compared across individuals. Neoclassical economics in the 1870s added the principle of diminishing marginal utility: as each individual's income rises, so does their utility, but each additional dollar received gives less additional utility than its predecessors. This made (and makes) perfect sense for each individual in

isolation, but it presents a problem when we aggregate individuals into a society. If 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 welfare-maximising (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 the mid-20th century.

The great intellectual achievement of so-called ordinalist theorists in the 1930s and 1940s was to persuade economists that their discipline could in principle say nothing about redistribution, which meant that economic theory could no longer be brought to bear in support of the welfare state. Lionel Robbins in 1931 argued that it is not in fact possible to compare the utilities of individuals one with another and hence to compute a utilitarian social welfare function (Robbins, 1931; Backhouse, 2006). 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. de V. 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.

Taken on its own, this abdication of neoclassical economics from having anything to say about policy issues where no pareto improvement can be demonstrated is harmless, because it leaves policy makers 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 pareto-improving changes.

Transcendental institutionalism and its critics

Rawls and Nozick, probably the two best-known 20th-century 'contractarian' philosophers of justice, have been jointly labeled 'transcendental institutionalists' by Amartya Sen (Sen, 2009). Sen's complaint, directed specifically at Rawls, is that while Rawls lays out the requirements for a perfect scheme of social co-operation on the basis of principles of justice that individuals would hypothetically converge upon in an 'original position' behind a 'veil of ignorance', he fails to address the everyday problems of relative justice that confront policy makers in a real world where injustice is prevalent. 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 (1) acting in a way that sustains the institutions, and (2) refraining from doing things that subvert the institutions.

The outcome was the failure of what looked at one time to be a potentially fruitful exercise in achieving social co-operation in pursuit of both efficiency and justice. We ended up with neither ...

I think that the proposed Regulatory Responsibility Bill is recognisable 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. In that spirit I anticipate that if the Regulatory Responsibility Bill were passed, a range of behaviours would be triggered in response as policy makers 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.

Many of the regulatory measures of the past two decades in New Zealand have fallen foul of the problem that rational behaviour is often 'unreasonable' in the Rawlsian sense, and that 'reasonable' behaviour in the Rawls sense is often not rational. I offer two quick examples.

The Fiscal Responsibility Act 1994 aimed to force ministers of finance to account fully to Parliament for all transactions that might affect present and future taxpayers, and to explain the full consequences of budgetary measures. It has left us with a policy environment in which politically-contentious transactions have simply been shifted off the Crown balance sheet, as fiscal policy has drifted towards increasing reliance on state-owned enterprise profits and asset revaluations, accounted for by separate entities over which ministers ostentatiously pretend to have little or no control and for whose behaviour they evade accountability. The emissions trading scheme, I have argued in a joint paper with Simon Terry, is another exercise in creating an off-balance-sheet vehicle to evade political accountability (Bertram and Terry, 2008, chapter 9).

Second, 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:

1. market participants behaving in a socially-responsible ('reasonable') manner;
2. information disclosure providing customers with information that they could use to countervail price-gouging and other abuses of market power; and
3. transparency encouraging good behaviour rather than simply providing a focal point for industry collusion.

As I have outlined elsewhere (Bertram, 2009), those expectations (assuming they were genuinely held by the policy

makers at the time) quickly fell foul of actual behaviour by corporate managers driven by profit and the quest for untaxed capital gains, in an environment where government took no effective steps to reward reasonableness or penalise rational but unreasonable (in the Rawlsian sense) action. The outcome was the failure of what looked at one time to be a potentially fruitful exercise in achieving social co-operation 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 and enforced.

1 Page 8, para 1.2: 'there can and should be less legislation …'.

2 Page 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'.

3 Page 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 (and same point page 20, para 2.24): 'the potential benefit … significantly outweighs the additional compliance costs placed on the Government by the Bill'; page 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 taskforce of the scale of the costs, nor demonstration of the quantified benefits.

4 I note in Tim Smith's article the assurance that the taskforce 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 think that in practice this is exactly where we would be heading.

5 A useful review of the partisan use of cost-benefit analysis in the Republican campaign to subvert high-quality regulation in the United States from Reagan onward is in Judis, 2010. The New Zealand Business Roundtable has promoted similar practices here.

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IPS Working Paper 10/08 May 2010

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