CHAPTER ONE

Role and Limits of Government

INTRODUCTION

Clearly New Zealanders aspire to secure a fair and thriving society. It is possible to distinguish debate about this objective occurring on two dimensions. First there is a debate about ends, about goals and values. Second there is a debate about the best means to achieve these ends.

There is a need to always carefully assess the nature of, and the trade-offs between, the various goals or values by which we judge our society. We need to be clear about our simultaneous desire for instance, for equity, efficiency and freedom. Because there is an identifiable problem does not necessarily mean things can be made better on all fronts, one has to accept trade-offs where they exist.

Later in this chapter we return briefly to discuss the nature of the generally accepted ends or goals of equity, efficiency and freedom. Chapter 3, and the Annex on Social Policy are devoted to detailed consideration of the problem of securing a fair society. This chapter however is primarily devoted to the discussion of the nature of social and economic interaction, and consideration of the means by which social goals can be and are achieved, and underachieved.

Perhaps the fundamental message of the whole chapter is that there are limits to private solutions to social problems, and limits to government designed solutions. The task then that faces a government is a comparative systems one. What institutional option out of a range extending from different types of privare arrangements through different types of government interventions is to be preferred? This chapter as a whole attempts to clarify the various factors relevant to this comparative systems approach to policy. It is useful nevertheless to broadly outline this approach at this stage.

This comparative approach involves two steps. Firstly identify the objectives and rationale of government policy and the problems it seeks to address. Any claimed problem with private arrangements should be subjected to detailed scrutiny. In the past the limits of private contracting have often been overstared. The need for empirical research, or information and analysis of private arrangements that may deal with perceived problems is central. It should not be assumed for example that particular groups are not competent to look after their own interest without some convincing evidence that extends beyond anecdotal observation. Further, every perceived problem should be subjected to detailed analysis as to its causes. For instance as indicated later, claims that there are divergences between social and private costs are not useful ways to express many perceived problems.

Secondly it is not sufficient to establish that a problem exists; it is also essential to establish that government can improve things. The essential element in policy formulation is therefore a detailed comparative systems approach. This comparative analysis needs to be based on an evaluation of the full impact of a government policy over time and its consequent impact on other areas of the economy. This suggests the need to avoid partial analysis of policy interventions and to adopt a more critical attitude to the likely hidden or secondary effects of any policy, given the problems of interdependencies repeatedly pointed to in this chapter.

Noble and clear objectives are not all that is needed for a government to perform well. It also requires a clear understanding of the nature and effects of its policy instruments, the limitations of central control and the appropriate level of government involvement.

In the next section we discuss the fundamental factors which have to be recognised as constraints on our ability to secure an ideal society. The problem then is one of identifying methods of social organisation that overcome or minimise the effect of these constraints, not the pursuit of options that assume them away. The third section of this chapter discusses how private arrangements seek to overcome these constraints and the limits to their success. The fourth section discusses the objectives and role of government in alleviating or overcoming problems with private solutions. A major theme of this final section is the need to recognise that the state is not an omniscient and omnicompetent solver of social problems, but rather is subject to largely the same pitfalls that face private solutions to social problems plus other ones. The concluding section attempts to identify the key factors that need to be considered in comparing alternative means for achieving social goals.

CONSTRAINTS ON THE ACHIEVEMENT OF SOCIAL GOALS

The basic constraint a society faces is the scarcity of resources (both physical and human) relative to the demands that can be placed upon them. There is a need to use physical and human resources efficiently, to make them go further, and to ensure that the uses to which they are allocated are those that are most highly valued. Scarcity then is the most fundamental constraint of all. It implies the need to find means to reconcile the demands of different claimants for the use of scarce resources. This process needs to ensure that resources are not wasted, and that they are employed in their most socially valued use.

Moreover we live in an interdependent world. One person’s use of a resource is likely to impact on another person either beneficially or detrimentally. Society needs to find methods of organisation that ensure interdependencies among individuals are resolved in a way that takes account of the welfare of all those affected.

A further constraint on the effective achievement of social goals is uncertainty. Uncertainty about the future and about the consequences of certain actions derives from what may be called the bounded rationality of individuals. Bounded rationality is the inability of humans to comprehend fully the nature of their environment, to anticipate or devise strategies to cope with change and to communicate effectively with each other. If individuals could fully anticipate and understand the network of causes and effects that exist, planning, both private and public, would be a relatively simple task. The future could be anticipated, and shaped, or strategies to cope with inescapable occurrences devised. Given the existence of bounded rationality, people must plan on the basis of a largely uncertain future, and they are forced to adapt to change and adopt strategies that minimise risks. Uncertainty then becomes something to be managed, never eliminated.

Beyond the problem of bounded rationality there is the problem of obtaining information. People may have the ability to make correct judgments but unless they have access to information, they will simply be unable to exercise their judgment. The acquisition of information involves costs, it is not free and for this reason it is also valuable. It is therefore something to be searched out, bought and produced. As with other scarce resources however, trade-offs have to be made. There is always some point at which it ceases to be economic to search for more information about problems or solutions. The benefits from further pursuing information need to be weighed against the costs.

A final constraint on our ability to achieve social goals is that individuals do not always have the purest or most saintly of motivations. Individuals are at least in part motivated by a concern for themselves. People thus have opportunistic tendencies. The organisation of society towards the achievement of social goals would be immensely easier if individuals were always generous, altruistic, honest and forgiving. When they are selfish, jealous, and spiteful then the costs of social organisation are raised. Individuals will therefore face difficulties in interacting and will need to protect themselves against the opportunism of others. The appropriate response to this problem is not to assume people ought to be different rather it is to devise means of organisation that limit the adverse consequences of opportunistic tendencies.

The problem of opportunism can be understood as a subset or manifestation of a more general problem-the problem of ensuring that individuals face incentives that align their interests with those of others. It is a problem fundamental to social organisation. How can people's incentives be aligned so that for instance shirking at the workplace, or unto-operative behaviour or white collar crime, or neglect of scarce resources is reduced?

In combination, these problems of scarcity, interdependence, uncertainty (or bounded rationality), the costs of information, and the problem of opportunism (or incentives) make social organisation towards desired goals an immensely difficult task. There will therefore be significant costs in social and economic interaction that may be generally described as transactions costs. The fundamental problem then is to discover methods of social organisation that relax or minimise these constraints in order to marshal1 the activities of individuals towards common or consistent ends. To ignore these problems is to ignore the fundamental issues in social organisation. In the next section we discuss the way in which private arrangements evolve to cope with these problems. The fourth section discusses the role of government and the ways by which it can seek to identify better methods of organising society or to enable better private solutions to evolve in order to secure society's goals.

THE ROLE AND LIMITS OF PRIVATE ARRANGEMENTS

We have identified the following problems underlying the task of social organisation: scarcity; interdependence; uncertainty or bounded rationality; information costs; and opportunism or incentive problems.

Social institutions have developed through a process of evolution in order to minimise these problems. These institutions do not fall like manna from heaven but arise from the efforts of individuals either alone, or in coalitions. This section seeks to interpret many of our institutions, organisations and practices as means by which individuals separately and as groups seek to adapt to the basic problems underlying social organisation pointed to above.

The Role of Private Property

In the case of scarcity solutions lie in finding a means by which different individuals' claims on scarce resources can be reconciled so that resources are not wasted but are employed in their most socially valued use.

The solution to the problem of scarce resources is the specification of enforceable rights. These rights may express relationships between individuals in respect of the use of scarce resources, or with respect to each other. Property rights perform the former task, human rights the latter task. The fact that rights express relationships between people implies the need for them to be mutually recognised for them to be observed. Rights can be backed coercively, by less formal sanctions involving custom, social mores, or by contract.

Clearly the existence of scarcity and the need to reconcile competing claims through the definition of rights creates a need for an institution that has a monopoly on coercive powers and adjudicates on the rights of individuals where necessary. This is perhaps the fundamental explanation for the existence of government. It is the ultimate safeguard to ensure that individuals in pursuit of their own self-interest reconcile their competing claims through peaceful means rather than waste resources, time and effort in violent and aggressive behaviour. In performing this role of enforcer and specifier of rights the Government is clearly not performing a simply technical function, but rather is expected to have regard to ethical criteria. In the next section, we turn to discuss more fully the role and limits of central government.

Before discussing how private property rights, enforced by the state, contribute to minimise the problem of scarcity and ensure the effective use of scarce physical resources, it is useful to identify the basic elements of those property rights. There are three basic elements. First is the right to use a resource and to retain income accruing from its use. Second is the right to change the nature of a resource (for example to put a factory on farm land). Third is the right to transfer these rights. The crucial feature of all of these rights is the extent to which they are exclusive or good against all comers, or against the competing claims of others.

Exclusivity in property rights creates incentives for individuals to use resources efficiently. To the extent that an individual or a group has an exclusive right to use and transfer a resource, they will face incentives to use the resource well and to develop it. With an exclusive right over land for instance one knows that if one fertilises the land, one will be able to capture the benefits of its improved productivity, without risk of this greater productivity being ‘stolen’ perhaps by a neighbouring farmer’s grazing herd. This improves incentives to carefully husband and improve the land. Further with exclusive rights one can sell or transfer the rights to others who may value them more highly. It can be claimed then that, depending on the way they are specified, exclusive property rights can improve incentives and enable more effective use and allocation of scarce resources, in comparison to a situation where no one can claim exclusive title. The institution of private property enforced by a government is an arrangement that enhances incentives toward careful husbandry of scarce resources. It can be seen then as an institution that contributes to both the resolution of the problem of conflicting claims to scarce resources and over time the potential relaxation of the constraint of scarcity, by encouraging investment.

The existence of interdependencies further creates the need to find means by which individuals reconcile conflicting interests. Not only does it have to be clear who has rights to use a certain resource but also whose views are to prevail in the case of conflicting uses. Thus can an owner of land erect a factory that pollutes a neighbourhood’s air space?

The problem created by interdependencies has in part been resolved in the same way as the problem created by scarcity. Individuals look to governmental institutions to define or change rights in order to balance the welfare of all, not merely the welfare of the owner. Thus owners may be prevented by the coercive powers of governments from particular types of use that impose costs on others. Restrictions on the erection of nuclear power plants or at a more common level noise control bylaws may be examples of this. However not only do individuals look to government to enforce rights, they also do it through voluntary contracting.

The Role of Voluntary Contracting

Interdependencies and the problem of scarcity are in fact resolved most frequently through private parties voluntarily contracting with each other to reconcile their interests. An example of voluntary contracting overcoming interdependencies is when neighbours come to an agreement about the nature of the fence that should separate their properties. Through voluntary contracting individuals can further organise solutions to the problem of scarcity. Individuals in local communities (before the state education system) contracted together to ensure provision of local schools. This can be seen as an organisational innovation that permitted more effective use of a local teacher's time-a scarce resource.

Trade is a process in which, through voluntary contracting, scarce resources flow to their most highly valued uses. In a situation where someone values a resource more highly than its current owner, a transfer of ownership is likely to be possible, with the purchaser being able to compensate the current owner out of the additional value he or she places on it. Thus through exchange, social welfare can be improved. Even the least technologically advanced societies practice barter, a form of exchange. The feature of modern exchange economies however is that they have developed a sophisticated monetary system (another institution) that facilitates exchange and avoids the problems in barter where both parties in an exchange have to have a commodity the other wants. Through voluntary contracts, either based on barter or facilitated through money, ownership titles to resources are transferred, ensuring that resources flow towards those who value them the most.

Voluntary contracting or market exchange is thus a powerful process that allows interdependencies between individuals to be reconciled, facilitates organisational solutions to the problem of scarcity and enables scarce resources to flow to their most highly valued uses. In the context of simple transactions or exchanges, market contracting has many beneficial features.

The general arguments for the use of markets or private contracting as potential means of solving economic and social problems tend to focus on three main features of markets-first how markets enable efficient use to be made of information, second how markets, through the price mechanism, co-ordinate individual actions and resolve interdependencies, third how market competition puts in place a selection mechanism that over time tends to guide resources to those users and uses that maximise the value of production secured from the resources, as measured by consumers' willingness to pay. Markets at their best resolve conflicts impersonally and ensure that over the longer term less efficient producers are penalised and the more efficient rewarded. In the following discussion we consider each of the above points in more detail.

The role of the market in ensuring efficient use of information becomes apparent when it is realised that the acquisition of information has costs, and in many circumstances is difficult to transfer from one person to another. In such circumstances it is better if those with ready access to information, or those in possession of relevant specialised information attempt to find their own solutions, rather than risk ill informed interventions by third parties. Various organisational forms have evolved which allow specialisation in the production of information. These include such things as rating agencies, brokers of various sorts, research departments within firms, private educational organisations, and labour exchanges.

The notion that the price mechanism is an efficient means of co-ordinating individuals' action is in many ways also based on informational considerations. A price system can operate in a low cost manner to transmit to individuals wishing to claim the use of scarce resources the competing claims upon its use or the returns the resources can earn in alternative uses, and also the costs of their production in one simple signal. In a similar way to traffic lights, the major virtue of the price mechanism is its simplicity in both signalling information and co-ordinating behaviour.

Substantial empirical work indicates that prices do reflect and convey information about the extent of competing claims and costs of production to market participants. On the basis of prices individuals are then able to make production and consumption decisions in a way that incorporates wider social claims on resources. Efficient markets force individuals to make choices about the priorities they have, reconcile their demands with those of others and further provide incentives for individuals to conserve the use of resources wisely. All of these are socially desirable outcomes.

Significant resistance to the use of private markets is frequently based on the view that individuals searching for private gain will be unconstrained resulting in undesirable consequences such as exploitation, unfair trading and monopoly practices. Such market practices however are often disciplined by the market itself through competition. If through exploitation or unfair trading an individual or firm can earn a return in a particular activity that is above that earned elsewhere then there will exist incentives for others to enter the market and compete, thereby undermining the longer term survival prospects of such practices. Thus economic rents and privileges tend to be transient in the context of competitive processes, and are likely to develop and persist in the context of arrangements that inhibit such processes.

Decentralised markets based on competition also have many virtuous dynamic properties that make them preferable in many circumstances to protected markets or centralised control. More important than the short run competition based on price, described in the last paragraph, is the competition that imposes a selection process on different methods of organising production and distribution, and at the same time provides incentives to discover new opportunities, new ways of doing things, new products and services. Competition creates an evolutionary process that tends to ensure that private ordering through markets is subject to evolution on all fronts over time, while also providing a check against abuse of power and privilege. Competition and markets can thus be seen as organisational arrangements that economically allow individuals to undertake mutually beneficial transactions while aligning the interests of the individual with those of a society.

Limits to Markets

Private contracting nevertheless clearly faces limitations. The major sources of problems with private contracting are uncertainty, information problems and opportunism which were discussed in the earlier section. In the context of uncertainty individuals will face problems contracting about future events. For instance a contract for the delivery of goods is complicated if the price of the goods may change according to movements in foreign exchange rates. Information costs also raise the costs of contracting. In particular individuals face costs searching out and evaluating potential contracting partners. An unemployed resident of Whangarei attempting to search for a job in Auckland or Wellington clearly faces considerable information problems. Finally, if individuals are opportunistic or incentives are not well aligned then people face costs contracting with each other. For example if one pays for goods in advance of delivery one faces the risk that the supplier will either not deliver or deliver poorly.

It is clear nevertheless that these problems are unlikely to be uniformly present in all exchange transactions. Voluntary contracting is thus likely to be efficacious in the context of simple exchange relations such as those involved in auction markets, where there are many buyers and sellers and information is easily obtained. Capital markets exhibit these features. Even less perfect markets can nevertheless work well. Consider the new car market. Information can be relatively readily obtained by viewing the cars on sale or by testing them, and one can compare prices for different makes and models by simply walking around the market.

Problems will arise with voluntary contracting however when there are difficulties in measuring the quality of the goods being sold. Measurement problems result from the existence of information costs and bounded rationality. They arise in goods markets where the goods are complex, but more particularly in the context of sales of services, especially expert services provided by professionals such as doctors, lawyers, or accountants.

Problems also arise where the parties to the contract are engaged in a long term relationship supported by investments specifically tailored to the trading relation and reliant upon its continuity (that is, transaction specific assets). An example of such a situation includes that of a manufacturer who requires a steady supply of a unique piece of equipment not used by anyone else. In these circumstances the supplier may have to change his/her production processes to meet the specialised demand and be unable at low cost to turn to the production of alternative goods. In these situations there are a small number of buyers and sellers and bargaining will be complicated by the existence of information costs, bounded rationality and opportunism. The parties for instance will need to safeguard their relation against uncertain events. The absence of large numbers of alternative buyers or sellers with a coincidence of needs further means there is greater porential for haggling over the terms of trade, and for opportunistic behaviour.

Such behaviour however absorbs resources. Consequently private individuals seek to anticipate such occurrences by crafting safeguards in their contracts, or by seeking out alternative organisational forms that minimise problems. Examples of such private endeavours to minimise the problems facing social and economic organisation are discussed below. The main examples are complex contracting, the firm, and the club.

Complex Contracting

Frequently when difficulties arise with private contracting, individuals develop organisational arrangements or practices which seek to minimise these problems. In more complex settings, or non-auction settings, non-standard or complex contracting emerges. Examples of non-standard contracting practices include entry fees, marketing restrictions and some types of franchising. These practices often appear unfair at first glance and suspiciously like monopolistic restrictions. However, they may be necessary in order to reduce uncertainty or scope for opportunism between the supplier and consumer, thereby making it economic for one party to invest in a specialised technique. Seen in this lighr such practices can be efficient. Frequently such non-standard or complex arrangements reduce the capacity of parties to a contract to renege or change the terms of an agreement. These restrictions can also be understood as efficiency enhancing particularly when there are the measurement problems or a small numbers bargaining situation pointed to earlier. In such cases the problems created for contractual partners by opportunism, are likely to be severe. For instance if the quality of a good or service is hard to measure then it will be easier for one party to cheat another.

Reliance on a third party may be resorted to in order to deal with contracting difficulties. This is likely to take the form of privately arranged arbitration procedures that are more sensitive to the needs of the parties than the use of common law courts constrained as they are to apply general rules with little ongoing knowledge of the facts.

Perhaps the most frequent method besides arbitration relied upon by private parties to limit opportunism is the creation of what may be called credible commitments. Individual contractors may deliberately agree to commit themselves at the outset. Such commitments may serve to tie their own hands at a later date from behaving opportunistically. The arrangements likely to emerge here are similar to the mutual creation of hostages. Examples include bonds required by landlords of tenants and vested pension funds offered by employers. These types of contractual arrangements can be understood as attempts by landlords to protect themselves against opportunistic tenants, and attempts by employers to protect investments they may make in the training of workers. Sometimes however these arrangements may appear unfair and explanations are advanced that suggest that one party is using market power to extract unfair terms. One needs to be careful however to examine the detail and background to the creation of these apparently unfair terms. They may often be better understood as attempts to safeguard integrity in a long-term relational contract.

In addition, problems associated with uncertainty frequently give rise to complex contracting. Individuals attempt to manage uncertainty. They take out insurance contracts, they buy on futures markets, they employ specialists either full-time or on retainers, they maintain inventories or they may merely self-insure through personal savings. Clearly attempts to anticipate all future events are costly. Examples of 70 page commercial contracts are not infrequent. In designing these contracting safeguards however individuals will weigh costs against benefits, and design contractual arrangements that best suit their needs over time.

To be sure, complex contracting restrictions that are observed may simultaneously serve the efficiency purposes outlined above or other antisocial (for example monopolistic) purposes. Here as elsewhere, where trade-offs are posed they need to be evaluated and the virtues of private arrangements not underestimated.

The Firm

The firm can similarly be interpreted as an organisational innovation that substitutes internal organisation of production for contracting across markets by autonomous agents, in order to minimise the costs of contracting. When a firm vertically integrates (or buys a supplier of services), it may be attempting an organisational innovation that reduces the costs of contracting. In these circumstances internal organisation may be more efficient than discrete market or complex contracting. Substituting administrative control for market relations may enable the pooling of information, improvements in communication and other reductions in bounded rationality, greater monitoring and control of opportunistic behaviour, co-ordination of production interdependencies and speedier resolution of contracting disputes. There may be gains both in adaptability and from improving integrity in exchange, by organising production within a firm. This is particularly likely in two cases. First when the parties are committed to a long term contracting relationship through the development of assets which are specific to their relationship and which have little value in alternative uses, and second when there are serious problems measuring the quality of a good or service provided, as in cases of team production.

The capitalist firm when viewed as an organisational innovation may be seen as socially beneficial in the way it may ensure the efficient production of goods and services for a market using team work. With team work it may be difficult to measure the contribution of each team member and shirking (opportunism) may become a serious problem. As the residual income or profits left after production is claimed by the owner of a capitalist firm he or she has an incentive to monitor production and minimise production costs in order to maximise his or her income. Over time this operates to the benefit of the consumer as, through the increases in productivity it enables, and through competition, prices may be expected to fall. Moreover the existence of the capitalist as a residual risk taker or the party accepting the costs of uncertainty is also relevant to the assessment of the firm as an effective organisational innovation. Fundamentally the capitalist firm may enable specialisation in the management of risk or uncertainty.

Within the community there is often a general expression of hostility towards large dominant firms. This view is based on a suspicion that the expansion of a firm into different activities has monopoly purposes. Recent research however suggests that attempts to expand or take control of different levels of production and distribution may be based on the efficient adaptations of private individuals to eliminate the problems experienced with market contracting outlined above.

It is true nevertheless that firms can behave opportunistically and exploit a monopoly advantage. The key question is, are there checks on this behaviour. In fact the number of firms operating in a market, or dominance, may not be the critical factors, rather-the ease with which new firms can enter the market, or the threat of competition to, or contestability of, the firm's activities may be the relevant element. If there are low barriers to entry then checks upon monopoly behaviour will exist. Frequently, where they exist, barriers to entry are in fact created by regulation. An alternative way of looking at the problem is to examine the costs of exit from a contracting relation that a purchaser or supplier has. If these are low then there are checks on behaviour. Firms further need to maintain their reputation. The potential loss of reputation therefore acts as a check. Monitoring by consumers, by potential rivals, and by Government (involving the threat of regulation) are all likely to act as a check on behaviour. Moreover co-operative organisations or alternatives to the capitalist firm may be expected to survive over time if they are more productive, so long as the legal framework is neutral. Basically one needs to be sensitive to the incentives of private individuals to eliminate practices which are exploitative and take precautions against them in mutually beneficial ways.

The major problem that large internal organisations create however is a weakening of incentives to perform. When transactions do not involve measurement problems, or specific assets, markets can be more effective. Within a large firm the checks on shirking can be comparatively low and the costs of monitoring and effectively encouraging efficient production may be weaker than when transactions are organised across markets. Further, bureaucratic rules and attitudes may hinder dynamic behaviour. These disabilities suggest that individuals may rely more on market oriented solutions to contracting problems, that may retain a higher level of competitive checks and incentives, such as those described earlier when we discussed complex contracting.

The above suggests that the firm can be understood more broadly as an organisational innovation or as a nexus of contracts between resource owners. Owners of labour, capital and land join together to provide goods or services to a market in an organisational unit that enables greater gains for each than independent or autonomous contracting.

Voluntary Associations

Other coalitions of private individuals or organisational forms can be identified which seek to pursue the mutual interests of members other than firms. These can be described as voluntary associations and include among other institutions clubs, churches, and unions. These coalitions can be understood as the creation of individuals contracting with each other to deliver a good or service of benefit to themselves. The services they provide may benefit their members exclusively or benefit the wider community (for example a club house versus a public park). While the problem of poor incentives or opportunism may arise in this context as well and limit the extent to which individuals may be able to achieve collective goals the problems should not be over-emphasised.

The main situation where opportunism may undermine the effectiveness of voluntary associations arises in the case of public goods. A pure public good can be defined in theory as a good that can be used by additional consumers at no extra cost, and for which it is not possible to exclude people from consumption (for example a radio broadcast in the absence of coding). In the case of a pure public good poor incentives or opportunism may lead some individuals to ‘free ride’ on the collective benefits achieved by others from which they cannot be excluded. It is suggested that such opportunistic behaviour may lead to the instability of clubs or associations which voluntarily attempt to deliver pure public goods. This free rider problem can however be over-emphasised. Generally, the stringency of the conditions for a good to be truly public, needs to be recognised. Few goods are likely to involve zero marginal cost for use across any significant range. Further, if the individual does not participate in clubs or associations that may seek to provide public goods then the quantity or quality of public goods that will exist will probably be reduced, hence a cost is incurred by non-participants and their 'ride' is not free but rather cheap. In the extreme in fact the collective good or service may not be provided at all. Moreover whether a good is truly public or not, depends on whether people can be excluded from its use unless they pay. This may depend as much on the institution used to produce it as on the nature of the good. For instance this is illustrated by decisions about whether or not to charge admission to amusement parks. Similarly, cable television has reduced the 'public' nature of television broadcasting.

The benefits of voluntary attempts to deliver goods versus compulsory attempts by central government that may prevent cheap riders, are that they may ensure the goods delivered are better tailored to the needs of the benefiting population, The decisions made on what goods should be provided are made by club or association members, and furthermore if a member disagrees with the ultimate decision of the group they can freely leave the group and seek another one that better meets their needs. In this way voluntary coalitions may be better able to satisfy demands for goods frequently seen to be of a public nature than centrally determined solutions.

Two limitations of such solutions however are frequently suggested. First it may be thought that in a heterogeneous society people joining clubs to provide services may lead to the segregation of peoples with consequent losses in social cohesion. Cohesiveness however is not valued above all else and it may at times conflict with another value, namely diversity. In fact, true social cohesion may only be attainable through greater tolerance of diversity. Second it may be suggested that with a mobile society such private solutions to the provision of certain public goods may be undermined, particularly with regard to collective goods that involve large set up costs. This suggests that reliance on voluntary club based provision of public services may hinder mobility. Mobility, however, has costs, and where it is highly valued one might expect individuals to find means to facilitate it. Thus there may be inherent tendencies towards networking where cohesion and mobility are valued by individuals.

Conclusion

The above discussion attempts to indicate the useful role of private arrangements as means for resolving conflicts of interests and achieving collective goals even in the context of serious organisational difficulties. It attempts to point out common fallacies or misconceptions about the poor effectiveness of private arrangements. At the same time it emphasises that private arrangements have weaknesses or face limits. In particular private arrangements are likely to face problems arising from information costs, bounded rationality, opportunism and uncertainty. Our discussion in the section which follows goes on to show that these problems are nevertheless common sources of failure of centralised solutions. A relative assessment of the abilities of private versus centralised attempts at solutions to social problems is therefore warranted. The selective emphasis of these problems in relation to one or other institutional option should be avoided.

THE ROLE AND LIMITS OF CENTRALISED GOVERNMENT

The Role of the State

In the section on the constraints to achievement of social goals we identified five problems which must be faced by individuals in organising their relations and activities. These were the problems of scarcity, interdependence, uncertainty (or bounded rationality), information costs, and opportunism (or incentive problems).

In the section on private arrangements we pointed to the way voluntary contracting has given rise to various institutions, organisational forms, and practices that serve to minimise or overcome these problems. In the process of voluntary contracting, rights or relations between individuals, both in respect of scarce resources and each other, are continually being defined, allocated, redefined and reallocated. The definition of rights through voluntary exchange is a dynamic process that among other things responds to changes in technology, preferences, income, relative prices, population and the need to minimise the problems indicated above. The process further involves decentralised decision making which enables quick adaptations to new information and incentives.

In this process of private regulation based on voluntary exchange, individuals seek to enforce and mutually recognise each others exclusive rights to use and transfer scarce resources in an interdependent world. Such rights based on exchange are characterised by a remarkable degree of durability or observance. The glue which makes a contract stick is the mutual advantage that underlies it. The creation of exclusive rights over resources through a contract is further likely to be socially beneficial as exclusive rights enhance the incentives for individuals to use resources efficiently.

One can identify at least five problems with purely private regulation and formation of rights. These problems are:

i Rights formed on the basis of contract alone are not likely to be respected by all individuals, rather only by those who are a party to the contract. This limited exclusivity of contractually based rights undermines incentives to use resources efficiently and may in fact undermine the operation of markets. Why exchange goods when theft may be an option?

ii Attempts by individuals to create absolute exclusivity of rights may lead them into conflict, either as individuals or groups. Depending on the co-operative tendencies of people, unless there is a more powerful force, or an organisation such as the state that can effectively monopolise coercive powers, the law of the jungle may prevail. This tendency, may lead to a situation where more resources are wasted on enforcing exclusivity, than would be required if there was an organisation such as the state that enforced rights on a generally accepted basis.

iii Third, the costs of contracting facing individuals may mean that scams quo rights definitions that are not socially desirable, continue in existence. Essentially the contracting costs facing private individuals attempting to change the current definition of rights may preclude an appropriate or socially desirable adjustment. Consider a status quo rights definition that effectively gave people the right to burn down factories. Because of the high costs facing factory owners in identifying and contracting with potential factory burners, such a rights definition is likely to persist and give rise to more burnt factories, lower employment and lower consumer welfare, when compared with an alternative rights definition that prohibited arson.

iv Fourth, it is usually felt that a purely private process of rights formation may not be ethically desirable. It may be seen to be potentially inequitable and potentially lead to a de facto situation where might defines rights.

v Finally it is frequently felt that private arrangements may provide insufficient safeguards for the dignity of people, leading to alienation with consequent losses in overall welfare.

Given the basic conditions of scarcity, interdependence and competing claims to resources the above arguments suggest, one can identify a socially desirable role for a state. It can be suggested that in the context of scarcity and interdependence the role of the state would be to enforce rights or relations between individuals.

In fact it can be suggested that the role of the state as a monopolist of coercive powers, that ultimately specifies and enforces property relations or rights, is central to the effective operation of markets. In such a context it may be inappropriate to speak of government intervention in markets. Government involvement in enforcing property and contracting rights may be necessary in order for markets to work. If governments may be the basis of markets, to speak of them interfering in markets seems slightly misplaced. Government involvement in markets is pervasive and therefore the notion of a market totally free of government intervention may be meaningless. Indeed even if a government did not exist one can suggest there would be a tendency for one to form out of the demand by individuals for an organisation to enforce exclusive rights.

The relevant questions then do not include whether or not Government should exist or intervene but:

i what can one say about the objectives or criteria that should guide social decision makers in a state?;

ii what can one say about the likely effects of various types of government involvement in private transactions namely tax, expenditure, regulation and ownership and therefore the appropriate nature of this involvement?;

iii what can one say about the likely limits to the state, or in other words what can one say about factors which may undermine the state's ability to actually achieve the objectives commonly expected of it?; and finally

iv what then can one say about the appropriate level of government involvement in private transactions?

The next four parts of this section deal with each of these issues in order. This is followed by a final section which summarises the most appropriate approach to government policy making, and a checklist of the major factors that should be taken into account.

Objectives or Criteria for Making Social Choices

As the ultimate enforcer of rights, social decision makers in control of the state have to make public choices about what rights are to be observed. In performing this potentially beneficial task, the state is usually called upon to have regard to generally accepted criteria or objectives. This section focuses on the nature of commonly identified social objectives the Government is called upon to pursue including efficiency, equity, liberty, public morals and the maintenance of human dignity, while largely assuming that the state can and will pursue these objectives.

Before proceeding however it is useful to examine why the state is usually even expected to adopt the objectives we are to discuss. In answering this question it is important to recognise the fundamentally political nature of rights specifications. It is clearly not possible to establish that individuals have any transcendental or natural rights. People do not have rights like they have noses. Rights are relative, they are grounded on the need for mutual observance and accommodation. Rights are things we give to each other.

Given the essential role of the state as enforcer of rights and the inability to establish any natural rights, it is clear that rights definitions are a matter of public choice and ultimately of politics. In making these public choices it is usually hoped however that the state's decision makers will use general criteria, and treat individuals impartially, and thus that it is a matter of reason not a matter of political favours, or arbitrary exercise of power. A right fundamentally specifies 'a relationship between people, and hence ethical considerations are raised. Even if the state does nothing, that decision is a social choice.

The justification for a normative or ethical expectation that the state should act impartially, or according to objective criteria in making social choices about rights definitions, probably lies in the notion that individuals should be treated as equally valued ends not means. An alternative justification may be deduced by considering how individuals might wish the Government to act, were they ignorant of their own situation and considering how the state ought to act in defining their relationships with others.

We next discuss the general criteria usually promoted as relevant to the definition of rights. Four main types of criteria or objectives are usually suggested to assess the appropriate rights structures to enforce. These are efficiency, equity, liberty and finally societal norms or morals. In each case we attempt to identify the essential nature of concerns.

Efficiency

It is important to clarify how efficiency considerations can be used to guide public choices about rights definitions. As indicated in the earlier section the problems of scarcity, interdependence, uncertainty, information costs and poor incentives can impose limits on private contracting. Many believe efficiency can be enhanced by government taxes, subsidies, regulations or government ownership to control or guide private activity. This section attempts to identify a useful framework for approaching efficiency rationales for government action.

A commonly argued reason for government action rests on a notion of market failure. Market failure is often inferred whenever there seems to be a divergence between private and social costs. This argument tends to focus on the problem of interdependence between individuals. It is suggested that private individuals may fail to take into consideration the costs or benefits which their activities impose or confer on third parties (an interdependency). Pollution is frequently suggested as a case in point. Thus it may be suggested that a factory does not take account of the cost to a neighbourhood of pollution. Public goods are another illustration. In this case a potential provider of a public park may not take account of the benefits of the park to others and under provide it. Defence is in fact the classic example. Similarly, there is the case of a natural monopoly or a situation where it is economic only to have one firm providing a good. Such circumstances are said to arise where economies of scale exist to such an extent that eventually there will be only one firm. By exploiting all the economies available this firm may be able to compete other firms out of the market. It is often suggested that a natural monopoly, given an absence of competition, may price too high and produce too little imposing a cost on consumers.

In each of the above cases and in other examples it is often suggested that there may be under investment or over investment in a particular activity in a purely private setting owing to the existence of third party benefits and costs (interdependencies) that are not accounted for. The third parties in the above examples are the local neighbourhood, potential consumers of public goods, and consumers of goods produced by a natural monopoly. In such circumstances it is suggested scarce resources will not be being used efficiently.

The fact that one individual's activity may impose costs or confer benefits on a third party is insufficient reason to discourage or encourage that individual's behaviour. First there is always a reciprocity to the argument or two sides to an interdependency that is frequently ignored. Second the pervasiveness of interdependencies is frequently ignored, and the reasons why government intervention to change rights is warranted in some cases and not in others is not sufficiently well clarified. Third one needs to assess critically the Government's ability to improve things by adopting a comparative institutional approach rather than assuming that an 'ideal world' can be achieved. The third reason we discuss more fully in the last part of this section. Here we focus on the first two points.

Reciprocity It is important to recognise that an interdependency is reciprocal or in other words two-sided. On the one hand a polluting factory may impose costs on a local neighbourhood, on the other it may provide essential or highly valued services to a large number of consumers. To prohibit pollution altogether would obviously impose costs on the factory and ultimately its customers. On the basis of a simplistic concern for costs imposed on third parties this would lead one back to allowing pollution. The neighbourhood and the factory have conflicting claims to the use of clean air. The problem is to decide what rights to use air should prevail. The relevant question therefore is should the factory be able to harm the neighbourhood or should the neighbourhood be able to harm the factory (and its consumers) and the task is to avoid the more serious harm.

The Pervasiveness of Interdependence It is important to realise that interdependency is present everywhere. Simply because one party is seen to bear costs or benefits derived from another's activity, is not sufficient to conclude those costs or benefits have not been accommodated by either explicit or implicit private contracting. Clearly, for instance when one observes a person in the back of a taxi cab one observes an interdependency. The driver is presumably benefiting the passenger and the passenger is benefitting the driver. These benefits will turn out to have been contracted for. Similarly when one observes an -aircraft landing scrip in a remote area it may appear that neighbours are unfairly bearing the costs of airplane noise. Upon further investigation it may emerge rhat this interdependency has been either explicitly or implicitly contracted for. For example the neighbours may have an explicit contract under which the airline provides them with discounted trips. Or they may implicitly have accepted the noise because the airline provides a service they rely upon to transport either themselves or their goods in and out of their remote region.

It is possible to see even in a simple case of interdependency however that contracting costs may cause problems. Take the taxi example. If the taxi driver and a potential customer do not speak the same language, the passenger will face additional costs getting to his/her destination. Moreover the potential customer and the taxi driver have to search each other out in order to contract. If the passenger cannot find the taxi stand no contract is likely to occur. This simple example illustrates how contracting costs may undermine the achievement of ideal worlds. They are nevertheless real costs that cannot be assumed away.

Contracting costs may lead parties to not attempt to mutually accommodate all interdependencies. In the case of a factory polluting an urban neighbourhood, the costs the local neighbourhood face if they are to contract with the factory to change its current activities are likely to be severe. Organisers will have to come forth. They will have to call meetings, attempt to get a consensus on how to bargain, there will be valuable time spent negotiating, there will probably be lawyers fees, title searches, emotional stress-and some members of the neighbourhood may simply attempt to rely on the actions of others, not contributing, yet benefiting from the exercise. In these circumstances even though the net benefits the factory confers (for instance on its workers and consumers) may nor exceed the value the neighbourhood places on clean air, the pollution may continue. If there had been no contracting costs a mutually beneficial arrangemenr might have been made. But the point is that such a world does not exist. Contracting costs are as real as the costs the factory faces in paying for irs electricity.

The above suggests that interdependencies are everywhere. In taxi cabs and in the air. They are not generally seen to be a problem when they are accommodated by contracting between the affected parties. Where they are seen to be a problem is where contracts to accommodate them are either non-existent or incomplete.—in other words while contracted-for effects are seen to be tolerable uncontracted-for effects pose a problem.

Uncontracted-for interdependencies either detrimental or beneficial are what are respectively usually termed social costs or social benefits, They are also frequently said to indicate market failure. However the reason why these so called social costs or social benefits exist, or why the market is said to fail (that is, there is no contract) is because there are costs to putting things right. Bur to distinguish such uncontracted costs or benefits as social, or as a case of marker failure is not useful. These uncontracted-for effects are private. Moreover the reason why the effect may not be accounted for is that it would be too costly for rhis accounting to be done. Thus the market can not be said to have failed. People have still weighed benefits against costs and decided not to attempt to correct an effect that is too costly to correct. Given the constraints this is socially beneficial. If these uncontracted-for effects are too costly to put right then society may be better off with them.

The way through this problem is to focus on the source and nature of the contracting costs not on the fact that an effect is uncontracted for. In other words attention should focus on constraints People will adjust efficiently to constraints. If the costs of contracting to eliminate an unaccounted for interdependency are too high (a constraint) people will not contract. The constraints however frequently can be changed. In particular the legal allocation and definition of rights affect contracting costs, This is the important point. It implies that contracting costs change with changes in the regulatory regime. The task for public policy making then is to focus on how alternative regulatory regimes change constraints, incentives, or contracting costs. The next step is to focus on the consequent changes in outcomes produced by the changes in regulatory regimes.

Different regulatory regimes or different allocations and specifications of property rights will clearly give rise to different contracting costs and therefore to different levels and compositions of outputs. Consider our earlier example and the alternatives of the status quo and giving people the right to burn down factories. Because of the high costs of factory owners identifying and contracting with potential factory burners, the latter regulatory regime or rights definition would give rise to more burnt factories than the former. The choice between the regulatory regimes then is based upon the likely effect of each, and preferences between the outcomes.

To summarise, one should avoid neglecting the two sided nature of interdependencies. One should recognise that uncontracted-for effects are likely to exist when the costs of contracting are too high. The costs of contracting depend on the regulatory framework. Different regulatory frameworks therefore produce different incentives constraints and therefore outcomes. Ultimately one should therefore choose between regulatory regimes according to preferences over the outcomes they produce, having analysed sufficiently the likely relationship between the regulatory regime and outcomes.

Efficiency and Government The role of Government on efficiency grounds then is first to assess what will be the effects of alternative policy regimes and secondly to assess what policy regime is to be socially preferred given the outcomes it is likely to produce. The first question is one of analysis and is a question policy advisers can assist with. The second is a question for elected representatives who have been selected by the electorate and are accountable to them for the choices they make.

If in any sense then efficiency can be used as a guide for social decision making it probably implies a concern for the maximisation of wealth in a society. It involves concern for ensuring valuable resources are not wasted and are allocated to their most socially productive uses, and it implies evaluating alternative institutional options according to these concerns. For example, the current laws against arson can be understood on this basis. In the end policy needs to be based on a comparative assessment of the effectiveness of alternative policies, not on a neglect of the two sided nature of interdependency or inadequate assessment of the sources of the problem.

In making social choices it is important that the full effects of government intervention are accounted for. Moreover the limits of individuals in the state to accomplish this task and assess the effectiveness of private arrangements needs to be acknowledged. The problems that Government faces in these regards is something we shall return to later in this section. It is nevertheless possible to suggest that through carefully selected interventions governments can improve things. Government interventions that change rights to minimise the costs facing parties contracting, will for instance create net beneficial results. The enforcement of exclusive property rights can be understood on this basis. Similarly allocating rights to the party that is judged to be able to make the most socially valuable use out of them will generate beneficial results. Thus it may be better to give parents the right to choose what food a minor should eat rather than the child, or someone who is less likely to care for the child's welfare. Further legislative interventions that minimise the likelihood of non-co-operative outcomes may yield beneficial results. This may underlie laws against contracts based on duress. Clearly if duress is an option one may not seek to resolve things by contract.

One can cite many cases where government provided an organisational means by which large social benefits can be achieved at relatively little cost. Examples include things like traffic lights, road rules, currency reform (for example decimalisation), spelling reform, calendar reform or standardised weights and measures services. A more recent example where the Government has sought to improve the husbandry of a scarce resource is the introduction of individual transferable quotas to fishing. Just like regulation of the use of land and the introduction of a land titles register, acceptance can be slow at first, but the gains from such institutional innovations once implementational details are worked out can lead to their acceptance as a part of our way of life.

Another largely co-ordination or efficiency argument for state action frequently raised relates to macroeconomic policy. It is frequently suggested that the processes of decentralised voluntary contracting based on the price mechanism and competition may not perfectly co-ordinate peoples' behaviour in a macroeconomic sense. Chapter 4 discusses the role of the Government's macroeconomic policy. The fundamental problem thar the Government faces is that while decentralised contracting may produce less than perfect short run macroeconomic performance, equally government policy can too, particularly given the information difficulties it faces and the lags and interdependencies involved in large scale macroeconomic intervention. It is always therefore a question of comparing alternatives.

Equity

In the following we use the terms justice, equity and fairness interchangeably.

In a context where resources are scarce and there are significant interdependencies the equity or fairness of private arrangements is likely to be raised as a concern. Moreover when a government defines access to scarce resources and resolves interdependencies through establishing rights, it defines relationships between people. The Government will therefore be making decisions that affect people's relative welfare, and concerns for equity will similarly be raised.

Equity concerns are further likely to arise if the problems of bounded rationality and information costs do not impact evenly on the population. Some groups for instance may be relatively less able to guard their own interests without assistance. In addition the problem of opportunism raises ethical concerns. People behaving opportunistically can attempt to exploit one another where circumstances permit.

Thus the factors we identified earlier as the basic problems underlying the efficient solution of social problems by private contracting further create concerns about the relative welfare of people in a purely voluntary setting. The state historically has been seen as the fountain of justice. Social decision makers in the state are called upon to redefine property rights, or regulate contracting practices or tax and spend money, in order to improve social equity. In the following paragraphs we discuss in general terms the different approaches to equity that are advanced as guides to the formulation of government policy.

The three main approaches to equity are, first, approaches which focus on outcomes or the nature of emergent social states according to some structural principle. Second, approaches which focus attention on the fairness of the processes by which particular social states emerge, and third, approaches which focus on starting points, or opportunities.

Calls for equality in the distribution of income is an example of an approach that focuses on outcomes with the structural principle advocated being that everyone should have equal shares. The problem with this approach is rhat it neglects procedural aspects. It is conceivable that unequal distributions could be fair if they are based on acceptable or fair processes of exchange between otherwise equal individuals. Differences in preferences in respect to work and leisure or in the amount of training a person undertakes, are likely to lead to divergences from an equal distribution of income and wealth that may nevertheless be commonly seen as just. One might argue for instance that it is fair that a skilled firefighter who risks her/his life should be paid more than a young clerk.

On the other hand an emphasis on process tends to suggest that whatever distribution ultimately results from a fair process is just. There is a tendency for instance to identify voluntary exchanges to be a fair process of distribution. One of the key problems however with this approach is identifying a fair process. It may be suggested that a just process is one that individuals would unanimously agree to. The problems in establishing such a standard are clearly immense. Further however, no matter how fair the process, it may be possible to argue that people are still concerned with outcomes. For instance collectively we might all agree that we do not like excessively unequal distributions of income or wealth. Once again however the problems in establishing such agreement are likely to be immense.

The above two approaches however tend to ignore starting points. A full evaluation of the justice or fairness of a society through time requires an assessment not only of outcomes, and processes of distribution, but also the starting points of individuals. This requires an appreciation of such factors as the history, socioeconomic background, and physical or natural abilities of an individual. These historical and contingent factors have implications for the consideration of social justice, usually embodied in calls for equality of opportunity.

The fundamental problem with private voluntary contracting is that it is based on an initial distribution of resources and natural talents. Concerns about the justice of private contracting are likely to arise to the extent that inequalities in these initial distributions are seen to impact both on the likely fairness of processes (for example voluntary exchange) and on the ultimate distributions that result. Concerns for the weak bargaining power of a contracting agent are based on these grounds. For example, differences or asymmetries in starting points (such as wealth, information, alternative opportunities) may mean that some can drive a harder bargain than others. While this may be true one needs to be aware of factors that limit these problems, including competition. Thus no matter how poor a buyer is, if there are many sellers to choose between, competition will drive prices down towards a level that reflects all the costs of production, including a reasonable return for capital and risk.

Clearly the Government's specification and allocation of rights through the tax benefit system and regulation and other means have distributional effects. These issues are discussed in more detail later in the brief. It has to be recognised however that decisions about rights structures based on a desire to benefit one group over another may involve efficiency trade-offs. It is possible for instance that the groups benefited do not maximise the social value of the rights they possess. Thus a tax or a subsidy may lead people to underinvest or work less. It has further to be recognised that markets perform an important allocational task. Through changes in prices, changes in demand and supply are signalled to resource owners and resources are guided to more highly valued uses. This process assists growth and improves the welfare of all. By interfering too much in the income received by owners the Government may adversely affect incentives to efficiently allocate and use resources. The necessity to evaluate trade-offs between efficiency and equity cannot be over-emphasised. The same is true when trade offs exist between other objectives. Trade-offs imply a perfect world may not be possible. It nevertheless remains true that in many areas of existing policy it may be possible to improve both equity and efficiency.

Liberty

The question of liberty or freedom is further relevant to the definition of rights. The freedom individuals face can usefully be thought of in terms of the level of barriers to their achieving desired ends. Barriers that limit individual freedom in circumstances where their freedom conflicts with others are the essence of enforceable rights. The basic rule advanced is that an individual's freedom should be as full and as extensive as that which is consistent with the freedom of others.

It is useful however to distinguish positive and negative conceptions of freedom. Negative conceptions emphasise limitations on others from interfering with the freedom of an individual. Positive conceptions emphasise that freedom is not only dependent on being free from unacceptable interference by others but also having the ability to achieve one's own objectives. Both conceptions involve the same basic structure, namely the freedom of an individual to achieve objectives free of constraining conditions. The constraining conditions focussed on by negative approaches are the interference of others; the constraining conditions focussed on in positive approaches include lack of access to resources.

Public Morals and Human Dignity

The state frequently also enforces rights structures based on widely held moral :. The freedom to engage in homosexual relations, and abortion are examples of this. The way in which social attitudes on such issues of public morality evolve make it difficult to say much about this motivation behind government's intervention in the rights of individuals.

It is possible however to identify a concern for the dignity of human beings as a relevant criteria for making social choices. In relation to dignity it is often suggested that private arrangements may lead to an undervaluation of dignity. If dignity were entirely a private value the parties to private contracts would provide safeguards for it. It is possible however to suggest that loss of dignity or alienation has important social consequences and is not merely a matter of private concern. Political and social competencies of individuals may be degraded with consequent negative social or systems effects. Concern with the dignity of human beings however may not be so much based on these pragmatic concerns about the consequences of loss of dignity to society as a whole, but more fundamentally on the view that people should be treated as ends not means. Whether institutional safeguards of dignity will be privately created therefore becomes an important question. If not then centralised solutions oughr to be considered. This concern can be seen to underlie the enforcement in law of human rights.

It is likely however that loss of dignity or the problem of alienation is nor uniformly important in all areas but rather is important for some. Public policy therefore may need to ascertain those areas where dignity is most important and examine possibilities for safeguards, beyond the general protection of human rights legislation. Labour markets are probably an area where the need for sensitivity to human needs for self and social regard become important. The abolition of slavery even when it is based on a voluntary contract, for instance designed to discharge a debt, can therefore be understood on this basis. Further some of the procedural safeguards in labour law may be examples where concern for the effects of process on participants, not just the substantive results, are being urged. Nevertheless it is possible to argue that individuals will tend to protect their desire for self-respect, and have regard to others, but not at all cost. In some circumstances they may be willing to accept lower standards for future benefits. Further the effects of centrally determined institutional safeguards of dignity on output and wealth should not be neglected. It is important therefore both to employ careful analysis of individuals' need for dignity and evaluate what trade-offs alternative institutional structures may involve.

Conclusion

So far we have discussed the role of the state as a monopolist enforcer of rights or relationships, and the criteria that are usually suggested for it to use in making social choices. All of this section has been about the problem of defining social goals, clarifying objectives, and identifying why they may not be achieved. This process of defining and clarifying objectives is an essential part of government policy making and relates primarily to a consideration of values or ends. The next section discusses the nature and consequence of the various means the Government has at its disposal for affecting social outcomes.

The Instruments of Government Policy and their Effects

In the first section we identified a role for the state as a monopoly enforcer of rights. In the second we discussed the criteria or objectives of government policy. The central conclusion emerging so far is that state decision makers can potentially perform a central role in assisting individuals to achieve greater welfare and minimise the problems facing individuals through a process of enforcing rights according to clearly specified and commonly accepted objectives.

Taxes, subsidies, regulations and government ownership are all examples of instruments by which the state specifies the rights of individuals. Taxes determine an individual's right to income accruing from the use of a particular resource. Subsidies similarly affect this right, and since subsidies to one individual must be financed by taxes on other citizens (fiscal or inflationary), or by debt to be paid back by taxes on future citizens, subsidies define rights or relationships between people. Regulation here is taken to cover both Acts of Parliament and Orders in Council, they clearly are used to defines rights. Government ownership similarly defines rights between individuals.

This section attempts to identify the consequences or effects of each of the above policy instruments. Typically the Government rarely acts through one instrument, but through mixes of them. For example when a government regulates it usually becomes the owner of a regulatory agency and spends money on it. Rather than speaking of government instruments or interventions it is perhaps more useful to speak of a policy framework or a government policy. Nevertheless while mixes of these interventions are most common, it is useful to consider generally the nature of the problems created by each of the above types of government intervention separately.

In the following few pages we therefore discuss the effects of the above policy instruments namely expenditure, taxation, regulation and state ownership separately. We further discuss the question of devolved local democratic control, this is clearly an example where the Government uses a complex mix of the above particular policy instruments. The pervasive use of local devolution in New Zealand leads to our treatment of it here as a special case. The discussion in each case is general and brief. The issues raised are discussed more fully in later chapters.

The discussion that follows focuses on the general nature of each insrrument and the problems each engender, not on the question of what is the best policy to adopt in relation to particular problems such as public goods, or monopolies. Ir is not possible to answer such questions in a general way, rather one needs to approach each area on a case by case basis, wary of the problems likely to arise with government intervention, and thereby utilising a comparative systems approach.

The best way to examine a particular government instrument (such as taxes, subsidies etc.) is in terms of its effect on the constraints individuals face. The major mechanism through which government instruments work is through the incentives they create, and therefore their effect on the behaviour of economic actors. In all cases there is a need to have as wide a regard as possible to the costs and benefits that would flow from the interventions. The comparison against which the assessment is generally conducted is either the status quo or outcomes under voluntary contracting.

Expenditure

Efficiency costs of expenditure can be direct or indirect. The direct efficiency costs of a subsidy arise through the way it alters incentives for individuals. Subsidies may discourage work, or encourage investment in areas where it would nor otherwise have been undertaken. There will thus typically be a forgone activity or opportunity cost that needs to be incorporated into decision making that involves government expenditure.

The indirect costs are related to the way it is financed and illustrate the interdependent nature of the economy. The indirect efficiency costs of debt financing relate to the effect that public sector borrowing has on the supply of capital and rate of savings in the economy. These are affected through various mechanisms but primarily through interest rates and expectations. Large public sector debt programmes put pressure on interest rates that adversely crowd out private sector activity. The indirect efficiency costs of expenditure when taxation is used as the means of financing are discussed in the next subsection.

Expenditure needs to be financed. If it is financed by creating money it will cause inflationary pressures involving efficiency and equity effects. If it is financed through taxes or debt financing then similarly it will involve both direct and indirect equity and efficiency effects. The equity effects are clear when government taxes one person to pay another. Similarly if debt financing is used then government will be placing a burden on future generations. This has a clear intergenerational equity effect. Clearly then for reasons of equity one needs not only consider the incidence of expenditure or who gets it, but also the incidence of the means of financing-who pays for it. If the subsidy receiver and the ultimate taxpayer tend to be the same people, then one needs to consider the reasons why one would want co incur the administrative cost involved in taxation to supporr such a spending policy. The issues that arise with respect to government- expenditure policy are discussed more fully in Chapter 4.

Taxation

Taxation also has both equity and efficiency effects. The equity effects depend on what one does with the taxes collected. Whether they are given back to the individual or not. If they are, then given the costs of taxation and expenditure, it may be better to consider tax credits or tax rebates to the individuals concerned rather than become involved in churning.

The efficiency effects of taxation arise through the way they change the incentives facing individuals and firms. The arguments here are similar (but often opposite) to the case of expenditure. Taxation creates disincentives to work and invest, and it encourages economically wasteful activities aimed at avoiding tax. These outcomes need to be evaluated, when taxation policies are considered and when evaluating the benefits from expenditure programmes. The issues which arise in relation to tax policy are discussed more fully in the section on tax in Chapter 4.

Regulation

The effects of regulation are probably more complex, less well understood and more hidden than those of expenditure or taxation. This fact makes it a particularly difficult instrument to assess. As a result it might be easier for regulatory instruments to be overused. It is possible to suggest that ignorance about the perverse effects of regulation may create a tendency for its overuse in the same way that smoking was widely tolerated before people knew about its costs.

It is possible to identify reasons why regulation can operate perversely. It can do this by preventing more effective private arrangements, raising the costs of contracting, protecting privilege, imposing a quasi-tax or cost on some and conferring a quasi-subsidy on others. Regulation on balance often appears to be a poor means for achieving equity objectives. Generally the tax benefit system is probably a preferable way to tackle most equity concerns.

State Ownership

It is true that ownership matters. As indicated in the earlier section on private arrangements, ownership is appropriate where there are significant costs to contracting between autonomous agents. An owner of a firm or organisation may typically have access to better information and achieve greater adaptability in securing supply. However while ownership can be beneficial it can also be costly.

Fundamentally the incentives of managers and employees of organisations are difficult to align with the goals (of the owners) of the organisation. This arises because of the problem of opportunism. Individual members of organisations have a tendency to pursue their own goals, to shirk and to featherbed, and to pay insufficient care in the use of resources that are owned by "the organisation" or someone else. This category of problems with ownership can be classed as principal-agent problems.

Whereas firms engaged in competitive or contestable markets supplying goods to a consumer face checks on their behaviour and need to ultimately serve consumers as well as other firms can, a state owned enterprise even in a contestable market can have greater leeway. This results ultimately from the fact that the state as owner has a tendency to underwrite losses and a greater capacity to do so through its ability to tax. While some checks involved in the managerial marker or the ability to hire and fire managers are present for both state and privately owned organisation, state owned organisations lack some of the controls present in most private firms and are frequently given conflicting objectives. As a result monitoring is more difficult. Large private firms on the other hand are typically open corporations, with their shares being traded on the capital market. If managers in a company do not maximise the goals of owners the company's share price will tend to fall. The value of the capital assets, or cash flow of the firm in alternative uses will at some point eventually exceed the share price and a takeover bid is likely to follow. The first change a successful takeover company is likely to make is to restructure the organisation and fire existing managers. This capital market check then serves to keep managers of private firms from pursuing sub goals and provides a mechanism through which control and monitoring systems are improved. These checks don't exist in the state sector to the same extent.

A fundamental problem that underlies concerns with state ownership is the problem of creating incentives to gather and provide information on the performance of state owned enterprises. Information on performance tends to be poor because the incentives to gather it are weak with state ownership. Many studies, however, indicate the relative poor performance or poor use of scarce resources exhibited by state owned companies. Typically these companies may have been nationalised to ensure they pursued appropriate social goals. However the information costs facing the Government trying to manage large commercial enterprises tend to result in the companies proceeding to do their own thing at a net social cost.

Ownership therefore has costs and the point to be borne in mind is that frequently social objectives may be more efficiently achieved through subsidies or taxes, or regulation of privately owned companies or contracts with them, rather than through state ownership. Chapter 2 discusses the comparative problems with state ownership in those areas involving commercial goods and services. In such areas state ownership faces serious comparative weaknesses.

In those areas where the state cannot secure an objective without ownership or there are net gains to ownership, then the state needs to be concerned on an ongoing basis to review and improve its internal management control systems. This quite simply is because in the state sector there are not the same processes of competition that lead to the survival of successful enterprises described earlier in this chapter. Thus better management has to be purposefully and consciously engaged in. These issues are discussed in Chapter 2 on public sector management.

Local Democratic Control

Local democratic decision making is frequently proposed as a possible alternative means for resolving conflicting interests and achieving collective goals, while avoiding many of the problems of extensive central government involvement. When local democratic units result from private arrangements the relevant perspectives for assessing such outcomes are those discussed earlier in relation to voluntary associations. Devolution of decision making power by central government to locally elected bodies through a centrally determined legislative framework however is the focus of our attention here. There are many examples of attempts at devolved local control in New Zealand particularly in social areas (for example education and health) but also in more commercial areas (for example electricity, the waterfront). Given its use in both these areas its effectiveness as a policy instrument will have both efficiency and equity implications. Although in effect it represents a case where the various instruments described above are being used in unison, its pervasive use justifies its inclusion here as a separate policy instrument.

The main advantage offered for decentralising control to local bodies is the likelihood that better solutions will result if those making decisions are close to the problems being addressed. This is based on the notion that those who have the information should make the decisions. This argument is used in support of all forms of decentralisation.

There are a number of reasons however for concern with the effectiveness of this particular institutional option. Fundamentally there is a need to be sensitive to the method by which decentralisation is achieved in these matters. In many cases the local electorate typically appears to exhibit weak interest in the prudent use of resources by elected managers. Particularly in cases where central government provides the bulk of resources which the local body administers. It is possible to suggest that so long as either or both the expenditure or control exercised by the local body is laid down from the centre the local electorate is likely to be relatively divorced from or disinterested in the management process. So long as the finance for expenditure is not raised locally by the local body, and so long as the source of the body's ulrimate control does not lie with the body itself but with the centre, the electorate is likely to exhibir less interest in holding the locally elected members to account. Given its pervasiveness, there is therefore a need to closely assess this form of intervention in terms of rhe accountability and incentives it creates.

Conclusion

Since the Second World War the size of Government and the nature of irs involvement in the economy has grown and changed rapidly. It is important therefore not only to try and clarify the objectives of government policy, but also the likely effects of the instruments or means it uses to achieve its objectives. At many times in the past government policy formulation could be characterised as falling foul of the old saying that 'the road to hell is paved with good intentions'. In short insufficient attention was paid to the second round effects of government interventions given an interdependent world.

It is therefore useful to clarify fundamental principles to be considered in the formulation of government policy. In the following we note some general points that should be borne in mind.

First there is a need for greater transparency and consistency in government policies and to increase the certainty and credibility of policy stances. This is an important objective to the extent that the complex government interventions such as taxes, regulations and subsidies increase the information problems facing private actors. This complexity may discourage economic activity. For example complex regulations on the use of land may reduce value maximising transactions owing to the uncertainty they create. The source of this uncertainty is the information costs of discovering righrs and obligations, and the potential for policy changes. A high level of government involvement in the economy may therefore discourage investment to the detriment of the economy's long term potential. This problem is particularly important in an international setting and given our reliance on overseas capital. Hence the need for transparency, consistency, certainty and credibility, pointed to previously.

Redistribution through the tax and benefit systems has an important role in achieving equity objectives. One nevertheless needs to be wary of the incentives and disincentives this form of intervention creates including the potential to create poverty traps. The use of targeted expenditure policies to, for instance, disseminate information, or enhance consumers' abilities to make choices in education or housing are also relevant. The Government needs to be careful however about the need to own suppliers of social services, given the problems of monitoring and incentives this option creates. Generally contractual arrangements with suppliers may enable the maintenance of better incentives and therefore enable the more efficient achievement of equity objectives. Ownership should only be undertaken after a case has been clearly established.

Generally regulatory intervenrions are not a useful way to achieve equity objectives. Regulation should largely be restricted to the definition of righrs to use resources in order to facilitate private contracting to minimise interdependencies. There is a fundamental need to be wary of detailed regulatory interventions restricting rights to contract. Such interventions may hinder dynamic efficiency. Chapter 4 discusses more fully government policy towards regulatory reform.

Finally and in general there is a need to carefully consider the often hidden second round effects of government policies, and be wary of partial analysis.

The Limits to Centralisation

So far we have discussed the role of the state, the objectives that it is commonly thought or expected to pursue and the effect of the means it uses to achieve its objectives. In this section we discuss a number of general issues one should take into account when considering central government. Sources of potential failure in attempts by central governments to minimise the problems of scarcity, interdependence, bounded rationality, information costs and poor incentives are identified.

Problems Common to Both Central Planning and Private Arrangements

Exactly the same problems that compound or undermine private arrangements undermine central planning. Thus central government attempts to improve the outcomes of private arrangements, or supplant private endeavours to solve the basic problems of scarcity and interdependence are similarly constrained by scarcity of resources, interdependencies, bounded rationality, information costs and incentive problems. In many ways, however, the problems may be more severe.

The basic point to bear in mind is that while the state can behave in a way that it 'ought' (that is, according to the criteria that were discussed earlier) and enforce efficient rights systems for the collective good, equally it can fail. The key distinction in approaching policy making therefore is between approaches which never get beyond assessing what a state 'ought' to do given some 'objective criteria of social choice' of the kind identified earlier, versus an approach that assesses what rights systems a state is likely to enforce given certain constraints and incentives, and then assesses this against alternatives. The importance of the latter approach is that it enables one to more closely identify how any particular expectations of state behaviour might be achieved, and further gain a fuller understanding of the limits to government, a central element to a comparative systems approach to policy making. Let us then turn to consider the problems facing governments.

In some ways the problem of scarcity may be exacerbated by central government. First its policies may distort the incentives of individuals. This is particularly so in the case of taxes and subsidies. It is also true however for regulatory interventions. Detailed, overly complex regulations may reduce exclusivity of property rights, or raise contracting costs or create barriers to mutually beneficial trades. Second, the state's ability to tax may mean it does not really face the true cost of resources with consequences for its use of resources and for other sectors in the economy. Similarly when it owns resources or organisations its incentives to efficiently monitor the use of resources may be weak. *Incentives* to conserve on scarce resources may generally be weak in the state.

Similarly the state's attempts to deal with interdependencies may in fact create worse outcomes. In part this reflects the basic fact of interdependency in the economy. An intervention in one market may have adverse consequences elsewhere that are unforeseen. The state's ability to improve macroeconomic performance is seriously impeded by this fact.

The above discussion points to the fact that, like private individuals, the stare will face difficulties dealing with scarcity and interdependencies. The reason of course is that the state is made up of individuals subject to the same limitations as private economic actors.

Indeed the problem arising from the bounded rationality of individuals may be more significant when one considers central planning. Whereas in a decentralised setting individuals accept risks and adapt to unexpected occurrences, with those who are caught out suffering the consequences of their mistakes, there will typically nevertheless be strategies that certain individuals may have adopted which are successful. These strategies are likely to survive and the system will benefit thereby. With central planning, mistakes tend to be excessively costly and impact on everyone, with few alternatives being available when things go wrong. The bounded rationality of central planners and the complexity of the world creates strains for the relative efficacy of centrally determined solutions. Indeed given typically economy-wide effects of government actions, the complexity of the problem solving state decision makers are expected to engage in may place even more severe demands on their bounded rationality than is the case for private planning. The only safeguard is conscious and purposive policy review. However given the fact that state decision makers may not bear all the costs of poor decisions and therefore may face weak incentives, this conclusion raises serious concerns.

Assuming central planners are as rational or more rational than others in the economy, then their judgements (for example on which industries are likely to be successful) are potentially likely to be as good or better than others. Even in such circumstances however central planners would face the problem of obtaining the information necessary to exercise their judgement. This leads to the impact of information problems on the state's decision making.

Centralised decision making faces major information disabilities. The information relevant to a decision may be hard to obtain. The information relevant will typically be diverse, and may include unavailable information on consumer preferences, or alternative production technologies, or alternative ways of organising activities. Alternatively information may be possessed by individuals who are difficult to 1ocate, or be of a nature that is difficult to communicate from one agent to another. If information is difficult to transfer then this means that it will be difficult to both acquire information at the centre relevant to decisions to be made, and then disseminate that information from the centre to the agents who are to carry out plans. The information costs underlying centralised decision making therefore militate against its successful execution. It is likely to be based on incomplete information with consequent adverse effects,

So far we have discussed the problems for state decision makers who face an uncertain and complex world with poor information. Let us now focus on the incentives facing 'the state' in relation to property rights. We have already noted that opportunism creates problems for private arrangements. Similarly however it creates problems for the performance of central government. Opportunism in the context of central government decision making and planning may exhibit itself in the form of political favours, featherbedding and waste of public resources. These problems are fundamental to an evaluation of the most suitable level and form of centralised state decision making in a society. The mechanisms through which opportunism and incentive problems generally work in the state are in fact more subtle and complex than are widely appreciated.

On the one hand definitions of property rights impact on the overall growth of the economy, on the other hand they impact on the rents accruing to particular groups. If coalitions of individuals can either gain direct control of the property rights defining power of the state (for example the coup in Fiji) or bargain with the state to change property rights (for example Federated Farmers, Business Roundtable, Federation of Labour, Public Service Association) then they can affect the value of their property rights (through tariffs, taxation, subsidies or legislation), or acquire better rights (through legislation).

From the redistributive societies of ancient Egyptian dynasties through the slavery system of the Greek and Roman world, to the medieval manor, there has been persistent tension between the ownership structure that maximised the rents to the ruler or particular groups, and an efficient and equitable system that encouraged economic growth and social equity. The dominance of agriculture in the western world prior to the nineteenth century resulted in struggles to control the state being associated with the distribution of landed wealth and income. Over more recent time, changes in the dominant interests within society, and the growth of pluralism have been associated with the radical changes in relative prices stemming from the Industrial Revolution. These changes have generated different outcomes in terms of property rights conflicts. The decline in the relative importance of land rent (and the landlord), the growth of manufacturing and services, and the growing share of income going to labour, transformed the structure of production and created new interest groups.

Property rights conflicts may appear more subtle now that they are largely nor associated with tangible resources like land, and also more complex given a pluralistic society. The nature of the interventions affecting the value and distribution of property rights are also far more developed including taxation, government expenditure, regulation and legislation. However conflicts'of interest and the state's role in resolving them are no less critical to the efficiency and equity of our economy than earlier ones. The state is a double edged sword. It can pursue generally accepted social goals or it can be diverted to pursuing the interests of particular groups.

In general government policy faces the danger of two types of capture:

i Capture from external sources-that is, lobby groups

ii Capture from internal sources-that is, its own bureaucracy.

The mechanisms of policy capture and safeguards against it need to be continually reviewed.

One of the clear ways through which inappropriate policy may result from external capture lies in the differential effects of policies on people. Frequently benefits are concentrated on particular groups while the costs of the policy may be dispersed. This sets up a dynamic process where those who benefit from the policy find it easier to organise and lobby for its introduction and maintenance, while those who bear the costs of the policy find it too difficult to organise an effective opposition.

The relation between a government and its own bureaucracy on the other hand can be described as a bilateral monopoly It can be suggested however that the relation favours the bureaucracy, that elected representatives are at a disadvantage in relation to their own bureaucracy simply because of an information asymmetry. The problem that the bureaucracy may hold better information about hon government services actually operate creates the potential for opportunism or subgoal pursuit by the bureaucracy including shirking, budget maximisation and generally inefficient policies for society as a whole.

What is sorely needed then is an ongoing detailed review of the operation and performance of the New Zealand system of central government. -This includes two things:

i a review of the workings of our representative government including the powers of the executive and its relationship to Parliament, and questions relating among other things to a Bill of Rights and the electoral system; and

ii a review of the structure, performance and organisation of the civil service.

In the absence of such a review, propositions about what services the Government ought to finance are reduced in relevance. Similarly however questions about how the Government should deliver whatever services are deemed necessary require an assessment of the way government delivery actually works, what are the pressures exerted upon it-what are the constraints, the relationships berween action and outcome, and the preferences underlying government activities. In particular what are the consequences of maximising behaviour on the part of economic agents within the Government's bureaucracies.

Once the above is done it is then important to conduct a comparative systems analysis on Government itself and distinguish the effect of alternative institutional arrangements on incentives and information and thus on behaviour at two ieveis:

i the political institutions which express the preferences for public services;

ii the bureaucratic organisations which supply these services.

The integration of these two elements, or the process of exchange between these instirutions, how it is structured and conducted is a further focus of attention. The key element here is the nature of the relation and the implications of this for management sysrems.

Chapter 2 on public sector management addresses the current system of organisation and management applying to the Government's bureaucracy, the problems with this system, and directions for reform. The reforms proposed seek to reduce the problem of internal capture, and to improve incentives, and information flows within Government. Constitutional reform, which defines the basic checks and balances, or the ultimate controls on external capture, the incentives on elected representatives, and the degree to which electoral preferences are adequately expressed, also needs to be reviewed but has nor been in any detail in this book. The issues relevant here include among other things the frequency and nature of elections, a Bill of Rights and the separation of powers.

Underground Economies and Crowding Out

Ultimately however perhaps the greatest irony placing limits on central control is that as government attempts to regulate or supplant private ordering, individuals respond by countering or evading that control. Thus individuals find ways around regulations, or adjust in advance of a change in policy, or simply create an underground economy. This tendency was particularly visible in New Zealand during the wage/price freeze, however it is also apparent overseas particularly in countries where there are extensive attempts at central control.

Alternatively the danger is that central control and private arrangements may not be compatible. In this way central control may crowd out private arrangements with consequent losses in flexibility, diversity and the evolutionary capacities of social organisations. This is particularly visible where state funded social services, or consumer protection legislation reduces the amount private individuals invest in market or self-insurance (for example for old age).

Level of Government Involvement in the Economy

It is clear that a government's activity in enforcing rights that may be the result of private ordering can be distinguished from government intervention in the operation of markets through taxes and subsidies, and similarly may be distinguished from regulations that may redefine privately derived property rights or enforceable contracting practices in a detailed manner. We discussed earlier the appropriate nature of government involvement in the economy after discussing the relative merits of its various policy instruments. A final question nevertheless remains as to the appropriate level of government involvement in the economy.

Whether the Government could or should effectively reduce its role to a minimalist task of merely enforcing property rights formed by private means, has to be approached on the basis of a relative assessment of the limits of private arrangements and the limits of centralised control with respect to generally accepted criteria for evaluating the processes and outcomes of societies discussed earlier.

The comparative systems approach to policy formation described earlier suggests that there may be little one can say about the appropriate level of government involvement in the economy, whether it should be more or less, without conducting a comparative systems analysis in every area of policy. Nevertheless there are reasons for believing the level of involvement in some areas may have become too high, and that there are tendencies to generate excessive levels of government involvement. First, in the past there have been tendencies to heavily emphasise problems with private arrangements. Second, frequently, inadequate attention has been given to clearly specifying government objectives. Third, inadequate attention has often been given to the often adverse and hidden impacts of government policy, and fourth, government policy has been too easily captured by special interest groups.

The tendency for growth in government may thus not be explained solely by the need for society to find effective solutions to complex problems, but also by government failure. This suggests the need for the Government to maintain momentum on the review of existing government policies. Further however the Government's own method of organisation needs to be reviewed. While some of the failures indicated above can be interpreted as human ones, ultimately they can be traced to institutional failure. In short there is a need to review the way in which Government organises itself. It suggests there is a need to adopt a comparative systems analysis of alternative ways of organising Government including our current system.

CONCLUSION

Government policy needs to move towards a comparative systems approach. This approach invites assessing alternative institutional structures (both private and governmental) according to the processes and outcomes they involve, utilising generally accepted criteria for making social choices. This will require in depth consideration of the goals of our society and of the means to achieve them. In comparing different means or institutions one should assess primarily:

- i their efficiency implications by examining:
  - a the incentives they create;
  - b their effect on the efficient use of information;
  - c the evolutionary or dynamic adaptability characteristics of the institution; and
  - d the scope they leave for voluntary contracting and decentralised decision making;
- ii their equity implications by examining:
  - a their effect on the opportunities of individuals;
  - b their effect on the fairness of outcomes;
  - c their effect on the fairness of processes.

A comparative systems approach is 'level headed' about the limits of Government, and the limits of private arrangements, eschews the blind pursuit of ideal worlds by recognising trade-offs between goals, and places emphasis on a detailed microanalytic approach or, simply, attention to detail including empirical evidence and argument.

Greater awareness is further needed of what we call government failure. Tendencies for governments to fail in the achievement of -generally accepted objectives and for them to pursue other objectives can however be reduced, although not eliminated, by institutional reform. We have therefore suggested a need for a comparative systems analysis of the way the Government organises itself-.

In undertaking this review the basic principles to keep in mind are:

- i *Clarify objectives*: It is important that the objectives underlying any particular area of government activity are clear.
- ii *Transparency*: There is a need to ensure that there is transparency not only in the objectives being pursued but also the means by which objectives are to be achieved. This implies for instance the need to make explicit possibly hidden subsidies.
- iii *Avoidance of capture*: There is a need to minimise scope for the capture of government policy when designing both the structure and processes used to formulate and deliver government policy.
- iv Incentives: There is a need to ensure incentives on individuals in the state are aligned to the achievement of government goals.
- v *Information:* It is important that efficient use is made of information, and that the costs of information are adequately recognised.
- vi *Accountability*: The design of incentive and information systems should attempt to enhance accountability of the Government's agents to their principals namely Ministers and ultimately the electorate.
- vii *Contestability:* Where possible in order to enhance both incentives and the efficient use of information, contestability of both policy advice and service delivery should be encouraged, either externally or internally.