

# Return to the Nation: Resource Rentals and Cost Recovery

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**Abstract.** The evolution of the Quota Management System of fisheries management in New Zealand has been accompanied by four innovations in the specific mechanisms used by government to collect revenue from commercial fishers and quota owners. These are: the introduction of resource rentals, the removal of resource rentals, the introduction of cost recovery and the proposed substantial modification of the cost recovery regime. This paper reviews the history of these innovations and identifies some of the key incentives associated with them. In particular, the interaction between these incentives and the overall incentive set suggested by a framework of secure property rights is examined.

**Keywords:** Fisheries Management, Resource Rents, Cost Recovery, Quota Management System, Incentives

## 1 INTRODUCTION

Since the introduction of the Quota Management System (QMS) in 1986, the New Zealand Government has implemented policies designed to extract a “contribution” from the fishing industry beyond that paid in the form of personal, company and consumption taxes. These policies have taken many forms and have had many justifications (both ex post and ex ante). It is worth reviewing these policies as they have had, and continue to have, important impacts on the performance of the New Zealand fisheries management regime, the economics of commercial fishing and the relationship between fishers and the government.

The primary purpose of this paper is to briefly describe the historical evolution of these chameleon policies, the contemporary attitudes that inspired them and the main incentives they established. An attempt will also be made to estimate the total amount of money collected under these policies from the fishing industry from 1986 to 1999. Finally, a set of policies will be suggested that support the positive incentives inherent in the QMS generally and which would promote the performance of the New Zealand fisheries management regime.

## 2 RESOURCERENTALS

When the first 29 species were introduced into the QMS in 1986, fishers were allocated individual quotas (ITQs) on the basis of their catch history modified by an assessment of their “commitment and dependence.” ITQ owners were required to pay annual resource rentals on the quota they held, irrespective of whether that quota was actually caught. The original intention

of the government was for the QMS to be self-funding. However, resource rents were not linked to the costs incurred by government in the management of commercial fisheries in any way so that the achievement of that outcome would have been coincidental.

Furthermore, resource rents were never directed towards a fisheries management account but were paid into the consolidated fund.

Resource rents were based upon a complicated assessment of industry profitability and a formula that was intended to tax away the “super profits” allegedly enjoyed by quota owners. These super profits were equated to the economic rents generated by the imposition of ITQ. ITQ created such economic rents by suppressing the “race for fish” and associated overcapitalisation. Under the policies of 1986, ITQ was denominated as a fixed tonnage. The government was required to buy back quota in the event that total allowable commercial catch (TACC) reductions were necessary in a fishery. The stated policy of the government was to minimise this contingent liability by setting resource rentals that drove the market value of ITQ towards zero. The other side to this coin was that the government was entitled to sell ITQ in the event that a fishery could sustain a higher TACC.

Resource rents were therefore a mechanism that the government hoped would achieve three distinct purposes simultaneously:

1. Provide revenue to offset fisheries management costs.
2. Minimise the fiscal impact of the government’s TACC management risk.
3. Capture some of the economic rent generated by TACCs/ITQs as a return to the public.

To paraphrase these objectives, resource rents were a cost recovery charge, a government insurance scheme and a redistributive tax on “unearned rents” rolled into one. The “low quota price” policy had two further imputed benefits: minimising entry costs to the industry and discouraging speculative ownership of quotas. The actual mechanisms for setting resource rents were reliant on attempts to identify “super profits.” It was small wonder then that resource rentals proved to be contentious, given their diverse objectives and extreme technical difficulty in application.

Even the term “resource rentals” was inflammatory, particularly with Maori who interpreted the choice of phrase as indicating claimed government ownership of fisheries. Such a concept of Crown ownership conflicted with Maori rights to fisheries secured by the 1840 Treaty of Waitangi. In fact, government officials and ministers clearly understood that the government had the right (and responsibility) to manage fisheries but did not own fish in the sea. However, the government was guilty of exacerbating this misunderstanding through loose rhetoric describing fisheries as a national asset that should be managed for the benefit of all New Zealanders.

Resource rentals rates were set out in a schedule to the Fisheries Act 1983. Those rates could be varied by the Governor General by Order-in-Council on the recommendation of the Minister of Fisheries. Rental increases were not to exceed 20% in any one year and the Minister was required to consult with the industry before making any recommendation. The Minister was required to have regard to:

- (a) *The value of individual transferable quotas for the species or class of fish:*
- (b) *The net returns and likely net returns to commercial fishermen for fish caught; including any difference in operating costs of foreign owned New Zealand fishing vessels and other New Zealand fishing vessels:*
- (c) *Any relevant changes in total allowable catches:*
- (d) *Any submission made to the Minister under subsection (6) of this section:*
- (e) *Such other matters as the Minister considers relevant<sup>1</sup>.*

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<sup>1</sup> Fisheries Act 1983, section 107G.

These consultations were lively affairs as fishers presented copious amounts of information supporting their contention that fishing was characterised by the absence of economic rents generally. The government therefore had great difficulty achieving its plan to steadily increase resource rentals so that ITQ prices were kept low. The government suffered little angst over this apparent failure because it was leasing and selling large quantities of ITQ. Sales of orange roughy, hoki and other quota raised \$76,953,400 in 1987. A further \$19,543,400 was raised by leasing such quota prior to sale. Against this income, the government was required to deduct \$42,391,000 in order to effect TACC reductions, leaving a healthy net revenue of \$54,152,400<sup>2</sup>.

By 1989, however, it was becoming clear that TACC reductions in the orange roughy, hoki and rock lobster fisheries were necessary. In 1990, the government therefore decided that the time was ripe to transfer the environmental risk in TACCs to quota owners. In 1990, the Fisheries Act was amended to redefine ITQs as a proportion of a TACC rather than a fixed tonnage. The industry issued proceedings against the government seeking \$129,870,000 in damages. These claims were settled through a complex compensation agreement whereby resource rentals were directed into a compensation pool for payment to quota owners affected by TACC cuts. Resource rental increases were restricted by statute to no more than the consumer price index during the four years they were directed to the pool.

In 1991 and 1992 two influential reports were produced that affirmed the merit of the QMS introduced in 1986, but highlighted the serious problems with the resource rental regime. Both reports advocated the replacement of resource rentals with a cost recovery regime. The first authored by Peter Pearse stated:

*In my opinion the guiding principle in distributing the burden of government charges should be cost recovery: that is, the required revenue should be raised through charges on holders of fishing rights, distributed among them in a way which corresponds, as closely as possible, to the costs they impose on the Treasury. This is the principle which is most widely acceptable, and it also focuses desirable incentives for economy in resource management and allocation<sup>3</sup>.*

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<sup>2</sup> Source: New Zealand Fishing Industry Association

<sup>3</sup> Building on Progress Fisheries Policy Development in New Zealand, a report prepared for the Minister of Fisheries, July 1991, p.15. Peter H. Pearse

The subsequent Fisheries Task Force advocated two primary legislative guidelines designed to address the complexity of fisheries management issues. These were to encourage trade as the means of satisfying demands for fisheries use rather than regulation and to apply the disciplines of cost recovery where possible. For instance:

*The government can ultimately determine the nature and standard of the compliance, research and monitoring services it will purchase in order to ensure environmental bottom lines are met. It is assumed that the costs of supplying these services will be recovered through user charges. Cost recovery is important to ensure the efficient production of those services.*

*Stakeholders in fisheries are often best positioned to decide what form services should take and what relative priority should be given to different activities. They may choose to purchase certain compliance or research services directly, rather than to pay for them through user charges. The specification of services to be purchased by the government and users is therefore a task which should be carried out within a context of close consultation between the parties<sup>4</sup>.*

The Task Force recommended that no catch history recorded after the 1991/92 fishing year should count towards allocation of ITQ and that surplus quota above that level should be tendered. They also recommended that resource rentals should be repealed following the expiry of the compensation accord.

Simultaneously, the settlement of Maori claims under the Treaty of Waitangi to commercial fisheries in 1992 greatly increased pressure for the abolition of resource rentals. By 1992, the issue of government charges had polarised into a choice between cost recovery and resource rentals. All of the best arguments appeared to favour the introduction of cost recovery. In spite of the expectation that cost recovery would collect more than annual resource rentals, there was a groundswell of industry support for the change on the basis that the industry would gain greater control over the specification and efficient delivery of fisheries management services under cost recovery. Cost recovery was also far more certain than resource rentals calculated by some estimate of economic rents.

Upon the expiry of the compensation accord in 1994, the Treasury identified a third option that had received little discussion; namely the retention of resource rents plus the addition of cost recovery! Resource rentals were restyled as “access charges” out of sensitivity to Maori concerns about implications of Crown ownership. Maori protested vigorously that the 1992 Deed of Settlement had been negotiated on the basis that quota owners would face either resource rentals or cost recovery, but not both. They argued that the proposal therefore undermined the value and integrity of the settlement. Faced with this opposition, the government dropped resource rentals and enacted cost recovery provisions within the Fisheries Act in October 1994.

### 3. COST RECOVERY

Although the concept of cost recovery had been discussed widely between 1991 and 1994, the statutory provisions that introduced a cost recovery regime to collect levies were drafted hastily with little consultation. While debate about cost recovery was largely free of the fundamental philosophical disagreements that characterised arguments about resource rentals, there was strong industry opposition to the actual mechanisms selected by the government for determining the cost recovery charges to be levied. The government was able to determine the quantity and quality of fisheries management services to be purchased, the identity of the service provider, the price of those services and the industry share of payment towards any joint goods

In 1994, the government had an effective monopoly over the provision of fisheries administration, research and compliance services. Traditionally, fisheries management services had been provided by the Ministry of Agriculture and Fisheries. The financial management and reporting systems of this Ministry had great difficulty accounting accurately for expenditure on individual projects. The need for improved transparency that arose with the introduction of cost recovery was an important factor in the establishment of a separate Ministry of Fisheries. At the same time, the research personnel, activities and resources of the Ministry of Fisheries (including control of the new 64m research vessel Tangaroa) were transferred to a Crown owned research agency, The National Institute of Water and Atmospheric Sciences (NIWA). NIWA was given a monopoly on the provision of most fisheries research services for three years after incorporating these activities.

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<sup>4</sup> Sustainable fisheries Tiakina nga Taonga a Tangaroa, report of the Fisheries Task Force to the Minister of Fisheries on the review of fisheries legislation, April 1992, pp. 24-25.

Under the statute, two consultation rounds were to be held annually to ultimately establish both the conservation and fisheries levies to be raised in a given year. The first addressed the nature and extent of the fisheries management services that were required for purchase by the Minister of Fisheries in the coming year. A detailed list of proposed services, including nominated providers and estimated costs, were prepared for comment and a wide range of “approved parties” were then consulted on those proposals. Approved parties include recreational fishers, Maori groups and environmentalists as well as representatives of the funders within industry. A later round of consultation, restricted to representatives of funders, was held to debate the formula by which cost recovery charges should be allocated within the industry.

The industry quickly adopted the overall principle that costs should “lie where they fall.” There were a number of issues that complicated attempts to apply this principle in practice, however. First, Ministry overheads were a substantial charge and there was disagreement about the allocation of such overheads between projects. Second, although the Ministry consulted on individual projects and collected levies related to those projects, the Ministry retained a high degree of flexibility to re-prioritise its activities within broad output classes within a year. This meant that certain projects were funded but not completed or less activity was carried out than budgeted for. In short, the Ministry had no effective accountability downwards to its industry funders for the delivery of projects. Accountability of the Ministry upwards to the Minister does not extend to activities below the output class level. For instance, fisheries compliance activities or projects fall within an output class “D5 Enforcement of Fisheries Policies” that covers estimated actual expenditure of \$18,195,000 for 1999/2000.

From an industry perspective, this lack of accountability was most unsatisfactory, equalled as it was by a lack of responsiveness from the Ministry to industry submissions produced during the “nature and extent” consultation round where expenditure decisions were made. For example, the industry produced substantial submissions in response to the Ministry white paper on required fisheries management services in 1996/97. That paper detailed a total of \$31,070,854 of proposed expenditure. After several months of consultation the final paper approved by the Minister was unchanged.

Having experienced cost recovery in action, industry members started to protest that the cost recovery regime was really just a device to levy a special tax from the fishing industry. Some officials confirmed that this was indeed their understanding of the regime and in December 1995, the Primary Production Select

Committee affirmed that the Fisheries Bill under their consideration should make it clear that cost recovery provisions were intended to recover a designated total amount from the industry. Therefore, no close relationship between costs and benefits would be necessary. These suggested “clarifications” were not incorporated into the final Bill by the time it was passed into law in 1996 and the final Select Committee Report indicated that further discussion on the principles of cost recovery was necessary.

Three more years of reports followed. These included: a Select Committee report that took approximately 12 months to produce, a report by an independent reviewer of the 1996 Fisheries Act, a Treasury led report on general guidelines for government cost recovery and finally a 1999 report from the New Zealand Institute of Economic Research (NZIER) on how to implement the guidelines from the Treasury report. The net result of this analysis was that the cost recovery regime remained fundamentally unchanged from its inception in 1994 to 1999. Those five years were characterised by a deteriorating relationship between the Ministry of Fisheries (the governors/service providers of the scheme) and the hapless industry funders of it. This conflict reached a level that threatened the sustainability of the cost recovery scheme itself and the government addressed this conflict by establishing a joint working group of officials and industry members to develop fisheries cost recovery rules. This working group was the first to include industry representation from its inception.

The working group made a conscious effort to place cost recovery policies within a wider framework of fisheries management policies. This entailed careful consideration of the appropriate roles and responsibilities of the government and quota owners in fisheries management. Cost recovery was recognised as providing potentially powerful incentives that influence the way in which those responsibilities are likely to be discharged.

*To achieve the objectives for cost recovery, and to ensure that both government and rights holders discharge their proper roles, it is necessary to change the way decisions on the purchase of fisheries services are made. The new cost recovery regime should allow fisheries stakeholders to purchase non-core fisheries services, at their expense. Government expenses, and levies on the industry, would then both drop. The Crown should continue to purchase fisheries and conservation services that relate to its core role.<sup>5</sup>*

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<sup>5</sup> Report of the Joint Working Group to Develop Fisheries Cost Recovery Rules, 1999

Core services would be taxpayer funded and purchased by the Ministry of Fisheries. The Working Group described a transitional process where the roles of funder and purchaser could be progressively aligned. The Working Group, attached a proposed revision to Schedule 1E to its report, illustrating its views on the activities that are core roles of the government that should be taxpayer funded and purchased by the Minister of Fisheries. The working group described a transitional process where the roles of funder and purchaser could be progressively aligned.

#### **4 INCENTIVES**

The assessment of fisheries policy effectiveness is frequently confounded by two related phenomena. The first is that, by definition, fisheries policy changes destroy the status quo and consequently there is no surviving counterfactual to use as a comparative benchmark. The second is that the purposes of the policy are seldom defined in terms that translate into expected measurable results for monitoring. This second phenomenon permeates the history set out above.

When the actual performance of the cost recovery mechanisms introduced in 1994 became manifest, one response was to re-style the mechanism as having the purpose of “taxation” rather than being a poor cost recovery system that required urgent reform. Similarly, a response to the practical problems (the calculation of “super profits”) and evident theoretical misconceptions (low quota prices are good) of the resource rental regime were not addressed but rationales for the regime were re-invented to fit the results it was delivering. In both cases there was reluctance to evaluate government revenue collection policies within the wider context of the fisheries management regime and the impact of those policies upon the incentives within that regime. This was a serious failing because of the central role of incentives associated with the ownership of ITQ in determining the ultimate performance of the QMS.

The theory of the QMS stresses the benefits of giving fishers secure property rights in their fisheries. In theory, they are thereby confronted with the full consequences (good or bad) of present day behaviour that affect the future value the fishery. Fishers will therefore seek to maximise the value of ITQ over time through fisheries management, harvesting and marketing innovations. None of these incentives apply under a resource rental policy designed to drive the price of quota down to low levels. Property rights with no value will not influence behaviour. The theoretical incentives of the QMS were also severely curtailed by

the fact that the government carried all of the environmental risk attaching to TACC setting between 1986 and 1990.

In the real world, profits and economic rents arrive in bundles. In practice, it was not possible to reliably distinguish economic rents attributable to the QMS itself from the economic rents attributable to all other factors of production. The rule of thumb adopted by officials was to attribute all rents and profits to the QMS. Consequently, the resource rent policy undermined the theoretical incentives of the QMS from 1986 to 1994. It constituted a major disincentive to investments that would conceivably enhance quota values. Even though resource rents were directed into the compensation pool between 1990 and 1994, there was substantial uncertainty over the level of resource rentals that might be set from 1994 onwards.

From 1994, quota owners have faced a set of incentives closer to those implied by the theory of the QMS. However, incentives are simply an impulse, whereas two other factors are required to translate impulse or desire into reality. These are capacity and opportunity. ITQ is a common property right and effective management actions, designed to enhance the value of ITQ, must take place at the fishery or collective level. This implies that quota owners need the organisational capacity to fund and carry out collective actions. These organisational arrangements had to be established and significant progress in the establishment of quota owner companies has only been seen since the mid-1990s. For instance, the leading example of such a company, the Challenger Scallop Enhancement Company was established in 1994. A number of other fisheries have established organisations to fund, develop and implement fisheries management plans.

These organisations are relatively flimsy because their membership and funding is voluntary. The cost recovery regime has been a disincentive to the establishment and growth of these organisations because there has been no ability to supplant the “required services” demanded by the Ministry of Fisheries with alternatives developed by fisheries management companies. Company research, administration and compliance activities can only be expanded by paying twice while the company attempts to prove that its management services are more effective than the “required” status quo.

#### **5 “IDEAL” COST RECOVERY REGIME**

Cost recovery is a strange and generally unstable state of existence. The basic scenario is that goods or

services are being produced by the government for the benefit of a defined group, who should therefore meet the costs involved in producing them. In other words, the goods and services are a type of private good generally described as club goods. This raises the question of why the government is in the business of producing private goods in a non-contestable market. One answer is that, if they were not produced by the government they would not be produced at all (or they would not be produced in the same quantity or quality). This simply raises another question, which is why the government is concerned with the capacity of the market to supply these particular goods and services. A common answer in New Zealand is that it is in the interests of the public that certain goods and services such as fisheries research and administration should be supplied. However, this argument exposes the unresolved and muddled thinking about the issue as it denies that the goods are private goods and establishes a case for public funding – not cost recovery.

If goods are private goods there is no persuasive reason why those goods should be supplied, specified or purchased by the government on behalf of private individuals or firms. Cost recovery for private goods is therefore an anomaly. Similarly, cost recovery from a narrow sector to fund the provision of public goods and services is hard to justify. Conventionally, the provision of public goods would be funded by broad taxes. This leaves the vexed question of joint goods (those that are both public and club). The practical experience of the Joint Working Group was that joint goods were in fact, primarily one or the other with relatively modest external benefits supplied to either the public or commercial fishers. Nearly all fisheries management goods and services could be cleanly classified as club or public, and the few joint goods existed fell within an 80:20 rule.

This suggested some useful rules of thumb which address the core conflicts at the heart of the New Zealand cost recovery regime:

1. Club goods, and predominantly club goods, should be specified, funded and purchased privately by the club.
2. Public goods, and predominantly public goods, should be specified and purchased by the government with taxpayer funds.

This arrangement maximises the potential efficiencies available from the optimum specification of the goods and services and the cost-effective delivery of those goods and services in a contestable market. The potential benefits available from clean funding accountabilities and management responsibility outweigh the costs of receiving a financial contribution from external beneficiaries of the activity if the price of that contribution is high transaction costs and less effective governance of service providers.

This practical arrangement would mean for instance, that the fishing industry would control and purchase commercial fisheries research that has a small public good component. This has been likened by environmentalists to “putting the fox in charge of the hen house.” However, when the industry “fox” has been given the rare opportunity to manage fisheries in circumstances where the positive incentives of the QMS have been given freer rein (Scallop 7) quota owners have proved to be careful resource stewards and innovative managers. The historical resource rental regime and cost recovery regimes have suppressed those positive incentives. Resource rents were a disincentive to investment and cost recovery has crowded out the opportunity to introduce innovative approaches to research and fisheries management. If the reforms advocated by the joint working group on cost recovery are fully implemented, the resulting improvements in the incentives confronting quota owners will move the QMS a step closer to realising its conservation and efficiency potentials.

**6 SUMMARY OF PAYMENTS NZ \$MILLION (current dollars)**

<b>Year</b>	<b>Resource Rent Voted (net of rebates)<sup>6</sup></b>	<b>Net Crown Quota Leases/Sales</b>	<b>Ministry of Fisheries Levies and User Charges</b>	<b>Required Conservation Levies</b>
1986/87	20.0 est.	54.152		
1987/88	20.0 est.			
1988/89	20.0 est.			
1989/90	20.0 est.			
1990/91	22.0 est.			
1991/92	22.0			
1992/93	18.3			
1993/94	20.5			
1994/95	6.7		26.2	0.396
1995/96			35.3	0.826
1996/97			32.8	0.998
1997/98			36.2	1.038
1998/99			35.1	1.252
1999/2000			31.5	1.149
<b>Total</b>	<b>169.5</b>	<b>54.152<sup>7</sup></b>	<b>197.1</b>	<b>5.659</b>

<sup>6</sup> Ministry of Fisheries Annual Reports

<sup>7</sup> *N.B. The government also budgets to receive \$5.5m of deemed values from commercial fishers every year. Actual charges have averaged approximately \$8m in recent years. Since the inception of the QMS the Crown has raised a further \$70m (est.) from this source which could be viewed as a form of quota rental raised by the government for fishing rights outside of the TACC.*