Can New Zealand Afford to

Replay the Economic Past?

NEW ZEALAND BUSINESS ROUNDTABLE
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The New Zealand Business Roundtable is an organisation comprising primarily chief executives of major New Zealand businesses. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

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FOREWORD

This collection of speeches, submissions and articles is the sixteenth in a series produced by the New Zealand Business Roundtable (NZBR). *The previous volumes in the series were Economic and Social Policy* (1989), *Sustaining Economic Reform* (1990), *Building a Competitive Economy* (1991), *From Recession to Recovery* (1992), *Towards an Enterprise Culture* (1993), *The Old New Zealand and the New* (1994), *The Next Decade of Change* (1994), *Growing Pains* (1995), *Why Not Simply the Best?* (1996), *MMP Must Mean Much More Progress (*1996*), Credibility Promises (1997)*, *The Trouble with Teabreaks* (1998), *Excellence Isn't Optional* (1998), *Turning Gain into Pain* (1999) and *Wake Up New Zealand* (1999).

The material in this volume is organised in six sections: economic directions; the public sector; industry policy and regulation; education and the labour market; social policy; and miscellaneous.

It includes two papers by Bryce Wilkinson, consultant to the NZBR, and an article by Cathy Buchanan and Peter Hartley, authors of the book *Equity as a Social Goal* published by the NZBR.

A full list of NZBR publications is also included.

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CONTENTS

ECONOMIC DIRECTIONS

NEW ZEALAND SOCIETY OF CORPORATE TREASURERS

CAN NEW ZEALAND AFFORD TO REPLAY THE ECONOMIC PAST?

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3 FEBRUARY 2000

CAN NEW ZEALAND AFFORD TO REPLAY THE ECONOMIC PAST?

Businesses up and down the country will have started the new year reflecting on the new millennium, the implications of the change of government, and the forces that are shaping the international environment in which New Zealand firms are increasingly operating.

The world economy looks to be set for a good year. The US economy is continuing to grow strongly, Europe is in better economic shape, and many Asian countries have bounced back from the economic traumas of 1998. The improvements of recent years have been driven by the efforts of many governments over the past two decades to free up their economies, the more stable environment for investment created by central banks, and the wave of technological innovations that are transforming business processes worldwide.

By and large, the 1990s were a better decade in terms of economic performance than the previous two, and the next 10 years could be better again. The economic environment in parts of the world, led by the United States, is starting to look more like that of the 1950s and 1960s with low inflation, higher rates of productivity growth and improvements in many social indicators. In the next 10 years unemployment rates could come down a lot further, particularly if more governments free up their labour markets and reform welfare systems.

The short-term outlook for the New Zealand economy is also favourable. Our export industries, including agriculture, are now generally enjoying the benefits of a lower exchange rate and stronger demand in world markets. The cyclical upturn could well deliver annual growth of 3 percent or more over the next year or two.

However, we should not allow the cyclical economic improvement to mask a number of underlying risks and concerns. Three, in particular, stand out.

First, there are always surprises in economic life, often nasty ones. We have not seen the last of such things as droughts, falls in world sharemarkets and regional economic crises. The previous government was far too complacent about New Zealand's economic position and was caught off guard by the Asian downturn.

Secondly, New Zealand's economic framework has become a lot weaker since the early 1990s, and economic performance has suffered accordingly. Large increases in government spending that have crowded out private spending and pre-empted tax cuts, the slow down in asset sales and the debilitating growth of regulations have all taken their toll on the private sector, and international competitiveness has been eroded. Whereas New Zealand had a low balance of payments deficit and falling external debt by the mid-1990s despite strong economic growth, it has since had a large external deficit despite much weaker economic growth.

In addition, since the early 1990s successive governments failed to maintain efforts to make the economy more competitive and robust, as well as to deal with outstanding problems in areas such as health, education and welfare. Many commentators were sounding warning bells but they were ignored. For example, a 1997 editorial in the *Australian Financial Review* observed that:

> Unfortunately, reform has slowed sharply in the past three years. [Ruth] Richardson's departure in 1994 marked a turning point. Little has been done since, apart from the passage of the Fiscal Responsibility Act and some tax cuts. And now a system of proportional representation . . . is hindering leadership and allowing fringe players . . . to stymie further reform.

While New Zealand was sitting on its hands, many other countries pressed on with reform programmes. Australia, for example, has now done practically everything New Zealand has done over the past 15 years and more. In particular, it has achieved a much more sound fiscal position than New Zealand. The Howard government's action to cut public expenditure and restore budget surpluses, at a time when the National/New Zealand First coalition government was boosting an already high rate of growth of government spending, put Australia in a much better position to weather the Asian economic storm. Although Australia is in many ways grossly over-governed, spending at all levels of government in Australia is set to fall to 32.5 percent of gross domestic product (GDP) this year, according to the Organisation for Economic Cooperation and Development (OECD). This is well below New Zealand's projected level of nearly 40 percent, which is above the OECD average. The overall tax burden in Australia is correspondingly lower, as is Australia's public debt.

The third concern that I believe many people in business in New Zealand will share is with some of the new coalition government's stated policy intentions. The overall thrust of recent National-led governments could hardly be described as business-friendly, and the Labour-led government has a chance to adopt a more positive pro-business stance. Prime minister Tony Blair describes openly New Labour in Britain as "the party of business", and the Clinton administration has been strongly business-oriented. But in contrast, New Zealand's new ministers have been saying that business is not going to like some of the government's plans, and I fear they are right. This does not augur well for the business environment in New Zealand, and hence for wealth and job creation.

Certainly, some of the government's early moves have not been encouraging. Contrary to the British Labour Party's themes of 'modernisation', these moves seem more like a replay of our economic past.

First off was a return to a more graduated tax scale with the increase in the top personal tax rate to 39 percent. This contradicted starkly the government's professed desire to attract and retain the talented professional and entrepreneurial people that New Zealand desperately needs. Firms will face higher costs as they are forced to adjust remuneration packages to retain such staff, and shortly we shall no doubt hear more complaints about growing pay inequalities. New Zealand learned for a time the many benefits of a flatter tax scale, and the move takes us back to the bad old days of widespread tax planning. The government will soon introduce a new range of tax avoidance measures that will add to compliance costs for businesses and other taxpayers.

Parliament now has in front of it the legislation restoring the state monopoly in accident compensation. If ever a social experiment was tested to destruction, it was surely New Zealand's accident compensation (ACC) scheme. It was an abysmal failure, and within a few short months the benefits of introducing competition in accident insurance were seen to be as dramatic as they were with telecommunications, taxis, airlines, rail transport, postal services and other industries. If the monopoly is restored, nothing is surer than that the ACC will sooner or later drift back to its unresponsive and inefficient ways and the benefits of choice will be lost. This proposal is a total no-brainer. There must be an all-out effort by business and others to persuade parliament to abandon it.

Next up will be proposals to turn back the clock on the Employment Contracts Act 1991 (ECA). The ECA was compromised at the outset by the foolish decisions to extend the scope greatly of the personal grievance industry and retain an activist Employment Court. The subsequent ministerial inertia by National was shameful. As a result, the country has lost thousands of job opportunities and all enterprises, including schools, hospitals and government agencies, face large risks and costs in dealing with under-performing staff. The Employment Court's shadow looms large over many of the so-called 'golden handshakes' in both the public and private sectors that have rightly caused public outrage. Far from remedying these flaws, however, the government proposes a return to union-driven collective contracts on the basis of 'good faith' bargaining. This will mean a field day for union officials and lawyers, but workers, employers and particularly the unemployed will pay the price.

Other back-to-the-past moves are the proposals to freeze or increase tariffs, and to reintroduce industry subsidies. To their credit, most people in the business sector in New Zealand came to accept the folly of Fortress New Zealand policies and were weaned off corporate welfare. There may always be foolish protectionist moves by other countries such as the recent US decisions on tariffs on lamb, but it makes no sense for New Zealand to copy them. Tariffs raise domestic costs and thus tax export industries, and industry subsidies favour some firms or activities at the expense of others and mean higher taxes all round. I hope most in the business community continue to support moves to full free trade, to say 'thanks but no thanks' to offers of subsidies, and to argue for lower taxes instead. A few people, however, still seem to want to make businesses wards of the state.

Further down the track, business is threatened with new takeover regulations, restrictions on mergers, and moves away from light-handed regulation of network industries. In the social field there are plans to go back to elected health authorities, abandon bulk funding of schools, boost subsidies to tertiary education, and increase superannuation, housing subsidies, welfare benefits and minimum wages. Many of these things are very costly and are certain to accentuate welfare dependency.

What seems to have been forgotten about virtually all of these policies is that New Zealand applied them in the past and they did not work. We moved away from tariffs and subsidies because they only propped up uncompetitive industries and we scrapped area health boards because they were a recipe for parochialism and inefficiency. We learned to our cost that interventions beget more interventions and micro-management, and that there needs to be a clear-eyed view about the proper limits of government and what a government can and cannot achieve. It seems futile to hope that a return to past policies will produce different results today. New Zealand was not a successful, happy, fair and cohesive society under its previous policies and a return to them does not seem to me to offer a solution to our present problems.

More generally, a coherent picture of the government's overall approach to economic management is not emerging. As finance minister, Dr Cullen reacted to the last GDP figures by suggesting the economy was becoming overstretched, yet he attacked the recent Reserve Bank move to nudge up interest rates. At the same time, the government's fiscal plans are clearly expansionary. These inconsistencies are a worry.

It is also worrying that Dr Cullen has resisted suggestions that the government should act to avert a credit rating downgrade by Standard and Poor's, which could only be negative for New Zealand. In my view, a downgrade is not inevitable given the current economic outlook, and could not be blamed on the position the government inherited. The stated concerns of Standard and Poor's have also focused on the government's tax and spending policies, changes to the ECA, the increase in the tax rate and higher business costs impacting on competitiveness. All these concerns are forward-looking and within the government's power to allay.

What also strikes me as curious is that the government's general policy orientation seems to run counter to worldwide trends. The government expenditure share in national income has been falling steadily across OECD countries as a whole since 1993; in the most dramatic case, Ireland, it has fallen from around 50 percent in the 1980s to under 30 percent this year, according to the OECD. The OECD's latest *Economic Outlook* indicates that on a variety of measures countries like the United Kingdom, Ireland, the United States and Australia are less regulated than New Zealand. Deregulation, privatisation, tax reductions, welfare reforms and other moves towards smaller government are worldwide trends, even in the case of governments that talk of 'third way' policies. The idea that New Zealand has been following some kind of economic 'experiment' that needs to be abandoned is sheer nonsense.

Just in the last few weeks, for example, I have noticed that the Labour government in New South Wales is promoting private sector competition in accident insurance; the Federal government in Australia plans to privatise its major remaining airport, Sydney, after the Olympic games, and China is floating 35 percent of Beijing International Airport; Germany, the Netherlands and Chile are privatising their postal services; India is deregulating its insurance market; Chile is selling its ports and water and sewerage utilities; Germany has deregulated its electricity market; the United States has finally decided to remove barriers to competition in financial services; Canadian farmers are demanding the abolition of the monopoly Canadian Wheat Board; the Italian government has sold the company that runs Italy's motorways; Australia is cutting its corporate tax rate to 30 percent, Germany to 25 percent and Ireland to 12.5 percent; and the United States is raising the retirement age for Social Security benefits to 67. These items come from just a random set of news reports; there are no doubt a host of other similar developments. I am not aware of any country that is planning a freeze on privatisation (which has led TransAlta to plan to exit New Zealand), raising top income tax rates, or contemplating some of the other moves that our government has foreshadowed.

To be sure, it is early days, and business should suspend firm judgments about the quality of the government's overall programme until a clearer picture has emerged. In its own interests and those of the country the business community must act responsibly, but that does not mean staying silent. Denying worrying trends does not build longer-term confidence in New Zealand. I am sure that the business sector will extend goodwill to the new government and be happy to assist it with tasks such as sorting out the mess the previous government made of its electricity sector reforms. Business will certainly not be taking the extraordinary partisan stance of the new leadership of the Council of Trade Unions (CTU) that dedicated itself to "getting rid of" the previous government: this must surely condemn the CTU to irrelevance when the government next changes, as governments inevitably do. The flipside of this is that business will expect the government to act responsibly and in the overall national interest, rather than the interests of narrow constituencies, to listen to business concerns and to show itself willing to modify unwise policies.

It should also be acknowledged that the government has won an election mandate, and is entitled to implement its core policies. Having such a right says nothing, however, about the merits of such policies: Sir Robert Muldoon secured a mandate in three successive elections, yet his policies were disastrous and ran the country into the ground. Our triple A credit rating was lost and will not be restored in the foreseeable future under current policies. In the Muldoon era, far too many people in business and the media who should have known better failed to criticise Sir Robert's foolish actions. Business leaders have a duty to do their homework and speak out responsibly to politicians and the public about measures that are likely to harm businesses, their stakeholders and the wider community. This is not a popular role, but it is hard to respect those who choose not to accept it, keep their heads down or leave it to the other guy. Public servants also have a duty to give governments frank, fearless and sometimes unpopular advice, and their performance in doing so is now more open to scrutiny.

In the final analysis, whether governments like it or not, businesses have to make their decisions according to the economic environment they find themselves in. If that environment is not business-friendly, and if businesses lack confidence, they will not invest or will take their business elsewhere. Likewise investment managers, whether domestic or offshore, have a duty to seek the best returns on their clients' funds and will shift money elsewhere if a country's outlook is unattractive. Short of reimposing exchange controls, which would be suicidal, governments are powerless to pre-empt those decisions. Similarly, highly skilled and entrepreneurial people are far more mobile in today's world, companies are scouring the world for talent, and the best and brightest will not stay long in countries that offer limited prospects. Particularly in remote parts of the world like New Zealand, governments must recognise these realities and work doubly hard to make their countries attractive places for people to work and invest.

So the government and the business community have close mutual interests in avoiding policy errors and taking New Zealand forward. Both want to promote a strong, cohesive, prosperous and fair economy and society. The minister of finance has stated a desire to see New Zealand's average annual growth rate raised to over 4 percent. During the election campaign the prime minister set a goal of reducing the unemployment rate to below 3 percent. These are laudable and feasible but very challenging goals. They are goals that the business community can relate to, and the electorate will ultimately hold the government responsible for achieving them.

But the government will lack credibility if it does not produce a realistic strategy for achieving those goals or, worse, if its actions positively undermine them. Policies to tax more heavily the most able and productive and to re-regulate the labour market can only work against such goals. So too will approaches based on the belief that all problems can be alleviated by greater regulation and spending.

Right now, I have to say I do not understand the government's strategy for achieving its goals. Many of the policies announced to date risk taking New Zealand backward, not forward. They seem likely to harm rather than help its growth prospects. My answer to the question: 'Can we afford to replay the economic past?' is emphatically 'no'. Thanks to years of hard work, New Zealand now has a better structured economy but it has failed to keep up the momentum of change, its businesses still have a lot of work to do to achieve international best practice, and its outlook is far from secure. We can ill-afford to lose further ground. There is a large gap between New Zealand's current performance and its real potential, and the business community and the government must engage constructively over ways of bridging that gap.

RESOURCE MANAGEMENT LAW ASSOCIATION CONFERENCE

NEW ZEALAND AT THE EDGE

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AUCKLAND
6 OCTOBER 2000

NEW ZEALAND AT THE EDGE

The conference theme 'New Zealand at the Edge' prompts a number of reflections.

Geographically New Zealand is indeed a peripheral economy – it has been called the last bus stop on the planet. In respect of trade we are a long way from the big markets of the world. We are not Ireland, on the doorstep of a wealthy market of 300 million people. This is a natural disadvantage.

In respect of investment we are out of sight and out of mind. Those making investment decisions in the major capital markets look at New Zealand for a few minutes each month, if we are lucky. Investors only have time to size up the big picture. Right now their general assessment is pretty simple: "Old fashioned left-wing government. Outdated policies. Odd electoral system. Falling currency. Bad returns. Sell". Many local investors made that decision some time ago.

The 12-hour flight from Los Angeles or Tokyo and the 24-hour trip from Heathrow are not fun. Most New Yorkers think the world ends at Long Island. New Zealand is a boutique item in international tourism. Our tourism numbers are tiny compared with other small countries like the Czech Republic and Ireland. We are competing with countries like France, Italy and Spain with their vast historical and cultural assets and their natural attractions.

The United States is the world's number one country of choice for immigration. Other new world countries like Canada and Australia rank well ahead of New Zealand. More countries are opening their borders to highly skilled immigrants as labour markets tighten. It will take years to recover from political opportunism over immigration from Asia.

Peripheral economies are up against it in a rapidly integrating world. The gravitational pull of major markets, investment centres, exciting career and business opportunities and cultural attractions is huge. These forces are at work locally – consider the geographical position of Gisborne or Invercargill compared with Auckland. Internationally the place that should be top of mind for New Zealanders as a cautionary tale is Tasmania. It is depopulating, it struggles for any sort of industry, it is a welfare colony and it is kept afloat by subsidies from mainland Australia. South Australia, another small peripheral economy, is also struggling.

It is often said that New Zealand is becoming a branch office economy. Many of our businesses are now integrated with their Australian or international parents, and some large corporates have moved their head offices offshore. But the same things are happening in Australia. Its largest listed company, News Corporation, is effectively a foreign company – it could delist in Australia. American or other non-Australian chief executives are heading up several of Australia's major firms. A recent *Australian Financial Review* article reported a major investor speculating that in five years' time "Sydney will be to the world what Adelaide is to the rest of Australia: a fantastic place to live but in the scheme of things largely irrelevant".

Elsewhere in the world the story is much the same. Canada is a society that has regarded itself as kinder and fairer than the United States, and has favoured more redistribution, regulation and welfare. Today Canada's per capita income is about a third less than that of the United States, two-thirds of its public companies are listed on American stock exchanges, and increasing numbers of the country's best and brightest are seeking their future in America. All countries are subject to the forces of globalisation today. Globalisation is like the dawn: you have to live with it.

Some factors are working against this gravitational pull. The costs of transport and communications are continuing to fall. The internet is changing the way the world does business and New Zealand has been a fast adopter of internet technology. There are time zone advantages. As wages and other costs rise in high-income countries, firms are outsourcing and scouring the world for alternative production sites. Opportunities will not disappear entirely if we continue as we are, but does New Zealand want to become a call-centre economy based on low wages?

Overall, New Zealand is obviously better off, not worse off, by virtue of the fact that the world economy is performing better than at any time since the 1950s and 1960s. It is obviously better for us that China gets rich than stays poor. For many individual New Zealanders, exciting new opportunities have opened up: we are all telling each other stories of the jobs our kids have in London or California. However, on balance, the new trends make it more challenging for New Zealand to maintain or improve its relative position. New Zealand's long-run slide was arrested in the early 1990s but the country is now going backwards again rapidly.

The lesson a country that is geographically at the edge must take from all this is that it must offset its natural disadvantages with advantages that it can create for itself. A small, remote country can be successful, provided it is open, competitive and uses its wits. It has to aspire to be better than other high-income countries in respect of the quality of its human resources, its business management skills and its public policies if it is to enjoy comparable living standards. It cannot just be the same in these respects; it must stand out. Nor is this a one-off challenge: change is continuous.

For a few years in the 1990s New Zealand stood out internationally, and started to close some of the gaps. We had a long way to go in terms of our education system and business skills, and still do. But our public policies attracted international attention and investment, the outflow of people turned around, and economic growth reached 7 percent in 1993/94.

Contrary to views that prevail to this day, few of New Zealand's policy reforms were radical or 'at the edge'. In most cases we followed worldwide moves in areas like privatisation, deregulation and tax reform. Where New Zealand was genuinely innovative, for example by establishing an independent central bank committed to price stability and in reforming public sector financial management, many other countries have since followed suit. But for a brief period New Zealand did have a generally sound economic framework, and reaped the rewards. Even for the 1990s as a whole, our average annual growth rate was 3 percent compared with 2 percent in the European Union.

From 1993 on, however, New Zealand lost direction and lost ground. More than anyone else, Jim Bolger and Bill Birch were responsible for the drift. Bolger dismissed those of us who argued that the momentum of change must be maintained as being "too ambitious". He had little understanding of the economic forces at work around the world: he used to ask why New Zealand's policies had to be better than those of other countries. He did not understand that the rest of the world would not stand still while New Zealand went out to lunch. Some people in the National Party have still not understood the damage done by two terms of dithering and backsliding. Only recently, Bill English was saying that the economy was so strong that not even Labour and the Alliance could mess it up. One hopes he has been reading recent economic indicators.

Today many of the present coalition government's policies could genuinely be called leading edge, but unfortunately they are leading in the wrong direction. They are outdated and out-of-step with those of successful countries. The policies that gave New Zealand competitive advantages are being thrown away: with the introduction of the Employment Relations Act 2000, firms are now being advised that even Australia has a better employment relations regime. Instead of striving for the best possible commercial law in areas like the Commerce Act 1986 and takeovers, we are harmonising our regimes with those of countries like Australia. We are compounding our natural disadvantages with self-inflicted ones.

As I see it, New Zealand is not so much at the edge as heading back towards the economic brink. We are falling rapidly down the rankings of international competitiveness. Michael Cullen and Jim Anderton think the low dollar gives New Zealand a competitive advantage; they do not appear to have noticed that the country with the strongest currency today, the United States, leads the competitiveness rankings. The loss of investment interest, outflow of talented people, falling currency and deteriorating growth outlook are bad enough. But all this is happening in a benign world environment – even Australia is growing at a rate of close to 5 percent. A frightening scenario for New Zealand would materialise with, say, a world sharemarket crash or another Asian crisis. In economic life these things happen at regular intervals.

Among the policy mistakes New Zealand has made in recent years are mistakes with many of its environmental policies. In the 1980s we learned some lessons. Those of us who urged governments to move away from command and control approaches and to rely more on prices and markets were well aware that such moves would produce both economic and environmental benefits. Some of New Zealand's major environmental improvements came from things like abandoning Think Big projects, scrapping fertiliser subsidies, abolishing land clearance grants and putting exotic forestry on a commercial basis. Often environmentalists were nowhere to be seen on these issues.

On many major environmental issues today environmentalists are still invisible or on the wrong side of the arguments. For over 10 years the New Zealand Business Roundtable (NZBR) has been pointing out that producer board structures in the dairy industry are encouraging over-production that is both economically wasteful and environmentally damaging. Only in the past couple of years has one environmental organisation woken up to the problem. For nearly the same length of time we have been advocating commercial approaches, including proper economic pricing, to the operation of roading and the water and sewerage industry. These are the only fundamental solutions to the disgrace that is Auckland's traffic congestion and the decaying infrastructure, waste and polluting discharges in many water and sewerage systems. However, these solutions look further away than ever under the present government, and environmental groups keep promoting alternatives like public transport that can go nowhere near solving the problems.

We seem to have great difficulty grasping two points that should be basic to environmental thinking.

The first is that economic growth and high environmental quality are not opposites: they typically go hand in hand. On both counts Switzerland far outdistances Somalia. Rich countries adopt cleaner technologies, build better infrastructure and can afford the trade-offs between development and the environment where they occur. Because richer is cleaner, environmentalists should be pro-growth, but typically they are not.

The second point is that governments, as owners and regulators, are far greater threats to the environment than private property owners and markets. The evidence is everywhere – from New Zealand's earlier experience, the environmental disasters in the former Soviet Union and Eastern bloc, and the devastating forest fires in the United States this year. It should not be a difficult conceptual leap to realise that central planning for nature will produce the same results that it did for economies – degradation, waste and decline. Yet the Department of Conservation (DoC) remains wedded to a command and control philosophy; it totally rejected the arguments of Peter Hartley and the Tasman Institute in their book *Conservation Strategies for New Zealand* in favour of greater reliance on decentralised approaches and market mechanisms. The same can be said for the Ministry for the Environment (MfE): its approach to biodiversity is pure command and control. The government is taking us back to a National Energy Efficiency and Conservation Strategy.

By shutting down Timberlands it has aborted a world-leading project in sustainable development. When will we ever learn?

The country also desperately needs some balance and objectivity in public discussion of environmental problems. Denise Church's introduction to the 1997 report *The State of New Zealand's Environment* reads like the famous primal scream *The Limits to Growth* published by the Club of Rome in 1972. Thirty years of doomsaying literature has told us that a population bomb is about to go off and that we are running out of food, minerals, forests, water, energy and just about everything we depend on for survival. Today most of these predictions look plain silly. Even Patrick Moore, once Greenpeace head, now says that most of the major environmental battles are won in the developed world and that many environmental movements are looking for funding by drumming up imaginary problems. But none of these realities intrudes into the advocacy of MfE and other agencies.

In the case of New Zealand, like many other countries, population ageing and decline are likely scenarios, yet many district and regional plans are predicated on the need to deal with massive growth. The prices of resources are cheaper than they were 30 years ago, meaning resources are less scarce. Even today, the real price of oil is less than a third of its 1979 peak and only some 50 percent higher than it was during most of the last decade. Biodiversity is now a fashionable issue, but how often is it pointed out that in the developed world, including New Zealand, species extinction peaked in the 1930s and has been declining ever since? Why do so many plans seek to protect versatile soils when the use of land for pastoral farming plateaued at 21 million hectares and is now down to 16 million hectares – which means that soil erosion is retreating and the country is reforesting? Are children in our schools taught that recreational fishing is improving, that the waters of the Hauraki Gulf get cleaner every year, that the vehicle fleet is now more than 25 percent more fuel efficient – thanks in part to tariff removal, which the Greens oppose, and hence the more affordable prices of new vehicles – and that the air in most parts of the country has been getting cleaner?

Anyone who goes around the country with their eyes open can see the improvements. Remember the countryside of the 1950s – untidy farms and pasture from one horizon to another. Now parts of the country are starting to look like Tuscany. The major garden centres sold 5 million native trees last year to private landowners. Perhaps environmental bureaucrats do not get out of Wellington; certainly none of this improvement is highlighted in MfE publications.

No one would deny that New Zealand has environmental problems, but our priorities seem seriously misplaced. I have mentioned the years of dithering over roading and the water and sewerage industry; the same could be said about smog in Christchurch. We seem to be incapable of getting serious about predators and the loss of native species. DoC spent $3 million fighting private development proposals through the courts last year and yet it says it does not have the funds to kill possums. Planeloads of bureaucrats fly off to conferences on global warming – an issue on which New Zealand will have only the most marginal influence, and which may turn out to be as much of a non-event as global cooling. We get worked up about toxic waste dump problems that are trivial compared with those overseas – Mapua is not the Love Canal or Bittenfeld.

The environmental bureaucracy seems oblivious to the costs that the Resource Management Act 1991 (RMA) is imposing on the economy. Phil Hughes, principal environmental investigator for the Parliamentary Commissioner for the Environment, recently wrote:

> There is outspoken concern in some business and farming sectors, particularly focused on the costs of compliance. The evidence that these are real and substantial costs has yet to be presented.

Does this man live on another planet? If DoC spent $3 million fighting private applications, who paid to counter their arguments? And, it is not just the business sector that complains. Most complaints come from small landowner families who simply cannot afford to begin the process required for a discretionary or non-complying activity. I am told Maori landowners are increasingly concerned that high compliance costs are simply encouraging rural Maori to ignore the process altogether. The wider economic costs of the RMA are undoubtedly much greater than the costs of complying with it. The minister of transport has admitted that major roading projects are held up by at least six years. The Environment Court has a backlog of 3000 cases. The total impact of these costs and delays must be enormous.

My view is that far from producing a world-leading statute, the review process in the 1980s that led to the RMA was hopelessly flawed. The consultation documents lacked a rigorous public policy framework – a problem that persists with MfE documents today. The focus on environmental effects was correct, but the scheme of intervention that was adopted retained many of the features of the Town and Country Planning Act 1977, and these have been reinforced by council and court decisions. Not once in the 382 pages of the act are private property rights mentioned. One of the more promising features, section 32, has been largely ineffectual: councils have ignored it, the Environment Court has limited its scope, and the recent MfE guide is a grossly inadequate discussion of cost-benefit analysis – it fails even to make it clear that a cost-benefit analysis is about benefits to people. Attempts in recent years to remedy problems with the RMA have largely failed, and the government seems likely to water down further the latest proposed amendments.

New Zealand needs to start over. Under the RMA we are fast progressing from a NIMBY (Not In My Back Yard) syndrome to a BANANA regime (Build Absolutely Nothing Anywhere Near Anybody). A proper review of the RMA would start by recognising the central importance of secure private property rights for both economic and environmental management, and the case for compensation if these rights are infringed. In respect of the legal framework, the starting point should be: 'What's wrong with the common law?'. For centuries the law of property, contract and tort governed development, and great cities were built on this basis. The burden of proof under such a regime falls on the plaintiff, not the developer. That such a regime is perfectly feasible today is demonstrated by the case of Houston which has no planning law to speak of. It is likely that the common law would be found wanting in dealing with two problems: the problem of hold-out, which may justify something like the Public Works Act 1981, and the problem of transactions costs where large numbers of parties are involved. Neither of these problems, however, would point to the need for an edifice as cumbersome and costly as the RMA.

My theme has been that a country like New Zealand that is on the geographical edge has natural disadvantages in an integrating world. If, in addition, it shoots itself in the foot with bad policies it puts itself at serious risk. The smallness and remoteness of New Zealand mattered less when it was producing a limited range of products for the British market, and when enterprising people had less obvious choices about where to live, work and invest. In today's much more open and integrated world it is a serious handicap to be remote and small, and one that is gravely compounded by a government that is so unconcerned with dynamism and reform, so preoccupied with old-style distributional issues, and so wedded to centralised and bureaucratic approaches.

Commenting on the country's current directions shortly after the accidental sinking of the Russian submarine the Kursk, some wag in Wellington put up posters saying "Terrible Tragedy in the South Seas: Three Million Trapped Alive". This overlooks the possibility of escape, however. In my view, a better symbol of what could be in store for New Zealand is Tasmania, as I suggested earlier. Official projections suggest its population could halve by the year 2050. Tasmania has been bedeviled by green politics and bad policies for 30 years (not to mention the Mixed Member Proportional (MMP) electoral system). A common currency with the rest of Australia has not prevented its decline. If Tasmanian trends take hold in New Zealand, Jeanette Fitzsimons will not have to worry about problems of population, economic growth and pressure on resources.

Clearly few New Zealanders would welcome such an outlook. Some of prime minister Helen Clark's gaps might be closed, but only because the most enterprising and talented people continue to leave our shores. Those left behind would be the old, the unskilled and the immobile – people you would think a centre-left government would be particularly concerned about – with no foreign treasury to support the dependent population. If New Zealand is to avoid becoming an economic museum and theme park like Tasmania, we cannot afford average economic policies, still less the impoverishing ones being put in place. Only exceptional policies will offset the natural disadvantages and give the country a chance to claw its way back up the economic ladder.

New Zealand could be exciting, dynamic, clean and prosperous given political will and public support – as the progress we made in the early 1990s showed. We do not need to be a society mired in envy and mediocrity. The biggest disadvantage we have is the ideas in people's heads. It would not be hard to create a more favourable climate for investment and job creation in New Zealand than in Australia. But the task is impossible if political and community leaders do not explain to the public why we should aim to do better.

Some of us have been making these arguments ever since Jim Bolger gave up on such aspirations at the end of his first term as prime minister, but no one has been listening. Is anyone listening now?

ARTICLE BY RALPH NORRIS FOR THE
NEW ZEALAND HERALD

A STRANGE SORT OF CHARM OFFENSIVE

AUGUST 2000

A STRANGE SORT OF CHARM OFFENSIVE

Some of us in business do not need lessons from Jim Anderton about understanding the poor and the real world.

I grew up in a state house and have spent my working life in the real world.

Self-serving comments about business people driving Mercedes and BMWs are a little hard to take coming from a politician with access to LTDs and an expensive ministerial house, and who has spent much of his life living off the taxpayer.

Moreover, these comments do nothing to advance intelligent public debate.

It is pure humbug to blame the New Zealand Business Roundtable for government policies.

We were critical of the 1980s Labour government's failure to reform the labour market and curb government spending. But it is shallow to imagine that there was any way of restructuring a debt-ridden and highly distorted economy painlessly.

We have spent the last six to seven years pointing out that the Bolger-led National government sat largely on its hands while other countries were improving their economies, and that the National-New Zealand First coalition was killing the goose that laid the golden eggs with its $5 billion spending package. The upshot has been economic under-performance: no groups have enjoyed the sustained gains that have been seen in successful countries in the past decade.

If our views had any influence, we are happy to share credit for New Zealand's performance in the early to mid-1990s when a better economic framework saw five years of solid economic growth, employment growth that was among the fastest in the countries that are part of the Organisation for Economic Cooperation and Development (OECD), a fall in the unemployment rate from 11 to 6 percent, a low balance of payments deficit and a falling external debt ratio, an upgrade in New Zealand's credit rating, a net inflow of people, and worldwide interest in New Zealand as a place to invest and do business.

We share Mr Anderton's concerns about poverty and welfare dependency but we differ about the solutions. The United States has been the stand-out country in the past decade in achieving near-full employment and cutting welfare dependency through flexible labour markets, welfare reforms and other policies that are in line with our thinking. The OECD's advice to New Zealand has been similar.

With few exceptions, OECD countries are continuing to reduce the scope of government in their economies, not pursue 'hands-on' policies. Ireland, a country mentioned by Mr Anderton, is a remarkable example: it has reduced government spending from around 50 percent of gross domestic product to a projected 27.5 percent next year (compared with 40 percent in New Zealand today) and has rocketed up the indexes of economic freedom.

I know of no other OECD country that is increasing its top tax rates, re-nationalising workers' compensation, re-regulating its labour market, halting privatisation, freezing tariffs, reducing choice and competition in health and education and making welfare policies less restrictive. The thrust of the coalition government's programme is out of line with general international directions.

Mr Anderton's professed compassion for the poor rings hollow when his government's policies are taking dollars that could be given to the poor and giving them instead to better-off people (eg university students and wealthy superannuitants) and denying work opportunities to many unemployed people with the job-destroying Employment Relations Bill. Such policies score poorly on grounds of fairness.

Mr Anderton sings the praises of the Mixed Member Proportion electoral system (MMP) yet as a senior member of the Labour Party he strongly opposed proportional representation. Is this principle or expediency? A test of his respect for democracy will be whether he supports the calls that have been made for the public to be given another say on MMP following the current parliamentary review.

The business community at large has been telling the government that its policies are damaging the business environment and putting the economy at risk again. It has been pointing to weak business confidence, the loss of investment interest in New Zealand and the outflow of talented people.

Currently the economy is being held up by buoyant world demand and a weak currency that is largely due to bad policies. That is no basis for sustainable growth.

The deputy prime minister's remarks to a group of people whose organisations employ one in 10 New Zealanders confirm the government is not listening. Businesses and investors will take note of a speech that was more offensive than charm. I know of no successful country whose government is at loggerheads with its major business sector.

Mr Anderton's outdated thinking also sends a clear message to bright young people who are comparing their opportunities in New Zealand with those in other countries that are serious about raising incomes.

Ultimately the costs of economic mismanagement do not fall on businesses and investors who have opportunities elsewhere: they fall on ordinary New Zealanders who are dependent on business enterprise in New Zealand.

Twenty years ago most political parties in New Zealand supported Alliance-type policies. Today most people recognise that they offer no positive prescription for New Zealand and support for the Alliance is at an all-time low. If Mr Anderton does not want to listen to business, perhaps he will listen to what ordinary New Zealanders are saying.

ACT NEW ZEALAND WELLINGTON DIVISION

PROMOTING SMALLER AND BETTER GOVERNMENT

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

WELLINGTON
7 AUGUST 2000

PROMOTING SMALLER AND BETTER GOVERNMENT

New Zealanders have always had a love/hate relationship with government.

From the earliest days of settlement they understood the importance of the core functions of government for building a nation. They were concerned to establish a rule of law, ensure public safety, provide other public goods such as roads and to maintain a legal currency. The Treaty of Waitangi can be interpreted as a project to introduce a British system of government, protect Maori property rights and safeguard law and order.

Government in the nineteenth century in New Zealand, an era in which the country established itself as a civilised trading nation with rising incomes, was small. At the turn of the century, government spending accounted for about 10 percent of national income compared with about 40 percent today.

However, as Michael Bassett documents in his book *The State in New Zealand: 1840–1984,* New Zealanders developed an appetite for progressively bigger government.

They moved away from the idea of limiting government to a rigorous concept of public good activities. They decided that governments could underwrite many of the risks of life, and developed cradle-to-grave social security. They used government powers to promote, regulate and protect industries. Governments were expected to 'do something' to tackle an ever-expanding range of economic and social problems. Politicians responded willingly: "We're from the government and we're here to help you".

However, New Zealanders found that big government brought its own set of burdens. Nationalised and protected firms exploited consumers. The regulated industrial relations system produced appalling work and management practices and disputes that held the public to ransom. The government-dominated education, health and accident compensation systems are a source of perennial dissatisfaction to those who use them and of frustration and low morale for those who work in them. As state welfare displaced private savings and insurance and voluntary initiative, it undermined self-reliance and family responsibility and led to increasing state dependency.

Some parts of the interventionist state were swept away by the economic reforms of the 1980s and early 1990s. However, many survive and, overall, the scope of government in New Zealand has barely shrunk.

Welfare spending, for example, absorbs a larger fraction of national income today than it did in the mid-1980s. The state remains dominant in education, health and ACC. The media unearth stories constantly of public service waste, extravagance and incompetence. The last 10 years have seen a new wave of stifling regulations in areas such as privacy, health and safety, human rights, consumer protection and the environment. These developments have taken their toll on the economy since the mid-1990s, and the present government is increasing the level of economic intervention and social control.

Writing recently in the *Financial Times*, Martin Wolf asked the question:

> What was the most dynamic activity of the 20th century? The answer is government. At the beginning of the century, the governments of today's high-income countries were already powerful. But what they were was nothing to what they were about to become. The 20th century was the era of the democratic Leviathan. But the growth is over. Ours is the age of retrenchment.

Even Bill Clinton has felt compelled to use the rhetoric that "the era of big government is over". Government spending and tax burdens have been falling steadily across the countries that are part of the Organisation for Economic Cooperation and Development (OECD) in recent years, and economic freedom has been increasing. Sadly, similar trends in New Zealand stalled in the mid-1990s and the country is now heading in the opposite direction.

Market liberals in New Zealand must renew their efforts to make the case for smaller and better government. We need to explain how voluntary exchange and competition have been engines of progress and prosperity whenever they have been allowed to operate. The collapse of the Soviet Union has ended the debate about central planning. Countries whose governments concentrate on securing for their citizens sound property rights, open and competitive markets, low inflation and low government spending will become more prosperous than countries whose governments protect industry, heavily regulate markets, extensively own and operate businesses, and neglect monetary and fiscal discipline in favour of budget deficits and high inflation.

There is no evidence that the poor are left behind by liberal economic policies. A recent study by two World Bank authors, David Dollar and Aart Kraay, looks at 80 countries over a period of 40 years. It confirms that openness to international trade (ie free exchange) increases growth. It also finds that over the last four decades the incomes of the bottom 20 percent of the population have, on average, risen fully in line with overall economic growth. This group also benefits from policies of openness to trade. Contrary to another myth, the relationship between economic growth and the incomes of the poor holds equally well for developed and developing countries; the poor are not 'left behind' in developing countries. Nor have the poor fallen behind as the world has become more 'globalised'; a virtually identical one-to-one relationship between growth and the incomes of the poor is found when the data period is divided into two sub-periods – the 1960s and 1970s on the one hand and the 1980s and 1990s on the other – and tested for each period.

The rule of law is found by the World Bank authors to benefit the poor just as much as it benefits the population overall. Controlling inflation is found to benefit the poor even more than better-off people; the poor are typically the group most harmed by inflation. It has been found that reducing total government consumption expenditure also disproportionately benefits the poor. Such a finding is consistent with a widely held view among informed commentators that the political influence of the middle classes typically enables them to capture the lion's share of government spending.

Thus, promoting smaller and better government partly consists of pointing out, over and over again, that the weight of evidence worldwide is firmly on the side of market liberalism. Moreover, governments virtually all around the world, irrespective of political label, are now privatising industries, reducing government spending and taxation, liberalising labour markets and cutting regulation. In this context, many policies advanced in New Zealand today can legitimately be described as reactionary. Here the government is reimposing state monopolies in areas such as accident compensation and strengthening them in health and education, re-regulating key sectors such as the labour market, the sharemarket and possibly the telecommunications market, and putting up income tax. Such initiatives constitute a reversion to the failed policies of our past. We seem to have forgotten the lesson that this road led the country to an economic crisis. After the experiences with PostBank, the Development Finance Corporation, the Bank of New Zealand and Australian state banks, how many of us thought we would ever see a People's Bank in New Zealand again? The idea would surely be ridiculed even in China today.

When condemning the follies of excessive government, it is nevertheless important for market liberals to reassure people that governments have an important role to play. From the Founding Fathers in America to the present day, the liberal tradition has always affirmed a positive role for government. We need governments to protect, not diminish, fundamental freedom and liberties, including freedom of contract and security in property rights. We need governments that preserve the rule of law, including by making themselves subject to it. We need an independent, uncorrupted judicial system. Governments must help ensure the provision of public goods where private initiatives are inadequate or ineffectual. There can be a fair debate about how far it is prudent for governments to go in filling the gaps left by a system of private insurance, mutual support and voluntary initiative, but most people accept the case for a state safety net of last resort. All these roles are consistent with a concept of limited government.

On the other hand, we do not need governments to be running lotteries, producing electricity, owning most schools and hospitals, providing an accident insurance scheme or subsidising private industry. The National government suffered political fallout last year from a succession of well-publicised mini-scandals in the public sector. Unfortunately, too few New Zealanders drew the right conclusion from these events: so long as the government is overstretched, it is bound to leave itself exposed to serious embarrassment when things go wrong. We should have been asking ourselves why we needed a tourism board in the first place. Instead of being shocked to learn about the salary of a presenter, we should have been asking why, in a free society, should the government be running a television station. After all, few would suggest the government should run a newspaper.

The incompetence of big government is corrosive: it destroys faith in politics and democracy. A reduction in the scope of government programmes is one of the keys to restoring confidence in the political process. The same is true of the tax system. So long as the Inland Revenue Department (IRD) collects one-third of national income, there will always be stresses and strains on the system, human errors and accusations of bullying and victimisation. Every political party in opposition declares that it will simplify the tax system and most fail to do so. The fundamental problem is the amount of tax to be collected. There will be no major improvement until the overall tax burden has fallen substantially.

In promoting smaller and better government, the basic approach must be to allow people to spend much more of their own money. It is economically costly to tax people in order to spend the money on private goods for the same people – be it in health, education, or retirement income. We sacrifice large amounts of potential national income by doing so – income that could make everyone better off. Tax rates could also be reduced if spending could be held while allowing pro-growth policies to increase the size of the economy. In Ireland, the ratio of government spending to gross domestic product (GDP) has shrunk from around 50 percent in the late 1980s to around 30 percent today. That has largely been due to economic reforms that brought rapid growth, coupled with the discipline of keeping the rate of growth of government spending below the growth rate of the economy. The result has been a dramatic fall in Ireland's tax burden, because the best measure of the tax burden is the level of public spending.

Some important lessons in promoting smaller and better government came from Ronald Reagan. He successfully projected a buoyantly optimistic view of America's future. He stood for some simple, powerful ideas. He wanted to reduce the power of Washington over people's lives but he also stressed that the right type of government can do much good. Central to his vision was the promotion of freedom around the world. In a speech to the Republican Party convention in 1988, shortly before the Berlin Wall was to fall, Reagan said:

> Our party speaks for human freedom, for the sweep of liberties that are at the core of our existence. We do not shirk from our duties to preserve freedom so it can unfold across the world of yearning millions . . . We have a healthy scepticism of government, checking its excesses at the same time that we're willing to harness its energy when it helps improve the lives of our citizens.

It is rare to hear New Zealand politicians speaking so unashamedly about freedom. That even includes ACT politicians. Yet ACT members typically have strong views about the freedom of the individual. The case for smaller and better government is based not only on its economic and social benefits but also, and perhaps ultimately, on its importance for liberty.

Almost by definition, a government that goes beyond its proper functions is compromising liberty. For instance, the Employment Relations Bill will reduce everyone's freedom to contract right through the labour market, from an unemployed person who misses out on a job to a small business that will be less likely to hire another person to serve behind the counter. The only unequivocal beneficiaries are union officials. The case against the monopoly powers of our producer boards is in the first place an argument about freedom: monopoly powers compromise the right of a dairy farmer or kiwifruit grower to sell the product of their labour to whomsoever they wish. Through excessive taxation the government confiscates effectively a person's hard-earned income and spends some of it on activities of low value or no value at all. Import protection detracts from freedom because it reduces opportunities to trade; poor families wanting to buy cheap imported goods will suffer the most from the government's decision to freeze tariffs for five years. Even poorer people in other countries are denied the opportunity to sell their goods to New Zealanders at a competitive price. The government's monopoly powers in health and education are denying freedom of choice to New Zealanders in key aspects of their lives and compelling the most disadvantaged members of society to put up with third-rate services. Examples such as these can be multiplied endlessly. In virtually all these cases, more freedom would mean more opportunity for people to make use of their talents and resources. Freedom and opportunity go hand in hand.

Smaller and better government can also be promoted by pointing to the social disharmony that results when a government strays beyond its core roles and substitutes coercion for the mechanisms of civil society. Markets are based above all on voluntary cooperation amongst individuals for mutual gain. When the government contents itself with enforcing the rules of contract, social harmony and prosperity typically flourish. Vast networks of transactions involving voluntary cooperation arise, all built on the simple principle that each side to an exchange has something valuable that the other seeks, and is willing to trade. When government blunders beyond its legitimate functions, as when it writes compulsory personal grievance provisions into the Employment Contracts Act 1991, almost everyone barring employment lawyers loses – such provisions are a tax on employment. The Employment Relations Bill will inject further strife into the labour market. We can predict less trust and cooperation and more strikes as workers and employers are pitted arbitrarily against each other.

Social cohesion is also threatened whenever government welfare spending goes beyond the provision of a safety net. If a government is taking resources from a large number of different sectors and redistributing them to others, political life becomes an acrimonious battle by some groups to acquire more resources at the expense of others. Consider the conflicts set in train when, 25 years ago, the Muldoon government brought in a universal national superannuation scheme with massively over-generous terms. As governments have had to retreat from the scheme there have been endless inter-generational battles – the reverse of social cohesion.

Often, proponents of policies that go beyond the scope of good government seek to justify their view on the grounds of fairness. On closer examination the proponent's case often evaporates.

Expressions such as 'equality' or 'social equity' are virtually meaningless in themselves. By equality do we mean equality of outcome? Almost nobody advocates that. Even equality of opportunity can never be literally realised. One could attempt to define a policy as fair if it redistributes towards those with comparatively low money incomes – if it 'makes more equal' the distribution of income in any one year. But even this idea runs into many problems. Money income in any one year often bears a very poor relationship to a person's lifetime income, because there is considerable fluctuation in most incomes over time. Money income is in any case a grossly inadequate measure of a person's overall welfare, because so many other factors affect our wellbeing. Moreover, any attempt to 'even out' money incomes will require substantial taxation, which soon reduces economic growth. Incomes in general then fall below their potential, including the incomes of the poor.

Rather than chasing the will-o'-the-wisp of some ideal distribution of income at a point in time, it is surely much fairer to concentrate on maximising opportunities for participation in the economy, on setting rules conducive to economic growth, and on providing a safety net for the truly disadvantaged. This last group of people are a proper object of our compassion. By contrast, it is not fair to attempt large-scale redistribution of money incomes on motives that, on examination, often turn out to be nothing nobler than envy of the rich and a desire to buy votes. Envy is distinguished from compassion by a simple test: compassion rejoices in raising up the poor; envy rejoices in pulling down the rich.

If 'fairness' in public policy means anything, it involves the idea that people in similar circumstances are treated equally by government. On this ground many of the Coalition government's policies clearly fail the test of fairness and are socially divisive. How can it be fair to reduce the rent of a family in a state house while providing no equivalent assistance to a family in exactly the same financial circumstances in private rental accommodation? The answer is that it is not fair: it is a straight vote-seeking decision. Many other recent initiatives such as the move to universal superannuation at an increased rate, the more favourable terms of student loans and the increase in the minimum wage redistribute income from poorer to better-off groups: they also fail any reasonable tests of fairness. The increase in the top personal tax rate also scores poorly on these tests; Cathy Buchanan and Peter Hartley in their recent book *Equity as a Social Goal* have exposed the weak case for a progressive tax scale.

Making the case for smaller and better government should also involve maintaining a focus on what really matters to people. On environmental issues, for instance, the real 'here and now' issues are not the possible threat of global warming or the risks of nuclear energy. Rather they are things like poor water quality, sewage discharges into harbours, smog in Christchurch, traffic congestion in Auckland, possums destroying native bush and predators threatening native species. Yet governments have been paralysed on these issues for years, and an incoming government shuts down a sustainable logging scheme on the West Coast that benefited the environment as well as the local economy.

The title of an influential environmental book was 'small is beautiful'. That slogan should also be applied to governments. The state has turned out to be the great over-promiser and under-achiever of our time. New Zealanders have endlessly demanded bigger and better government and are endlessly frustrated when it fails to deliver. Hope springs eternal that a new broom will somehow make it work. When it does not, politicians and government are brought into even greater disrepute. This is bad for everyone. It is well past time for a fresh approach.

That approach should involve explaining that governments go wrong when they move beyond their core public goods functions and start to produce private goods as well. In their equity roles governments go wrong when they move beyond underwriting access to services such as health and education for those who cannot afford them and providing a decent safety net, and engage in large-scale redistribution instead.

In the process, governments become overstretched and fail to discharge their essential responsibilities. They perform their core functions badly in areas such as crime and conservation. Liberals must argue that if governments focus only on those things that we need governments to do, there is a better chance that they would do them well.

Finally, making the case for smaller and better government should involve promoting a vision of New Zealand that is positive and in the best sense nationalistic.

A true picture of the choices facing New Zealand as a nation state needs to be painted. On the one hand we could have a prosperous country, growing both in wealth and population. It would be a country with world class social services and low welfare dependency. It would be attracting many bright, enterprising and skilled people. And it would be playing its part confidently on the world stage and in international forums as a respected democratic nation.

On the other hand, it is not hard to envisage a scenario of New Zealand as a country that is depopulating and declining in wealth. Dependency would be rising and the quality of social services deteriorating. Those with get-up-and-go would be getting up and going, especially our enterprising young. On the world stage we would be strategically insecure and losing influence, because we would be failing to provide sound stewardship of the national resources we had inherited.

This second option is hardly an alarmist picture. It fairly closely describes the Muldoon years. It resembles the fate of Tasmania and other mismanaged peripheral economies. Which road we end up taking will depend on how well the arguments for smaller and better government are made.

ARTICLE BY ROGER KERR FOR
THE DOMINION

NEW ZEALAND WOULD NOT WIN THE BLEDISLOE CUP FOR ECONOMIC MANAGEMENT

JULY 2000

NEW ZEALAND WOULD NOT WIN THE BLEDISLOE CUP FOR ECONOMIC MANAGEMENT

On his recent visit to Australia, finance minister Dr Michael Cullen attempted to allay fears about New Zealand's current policy directions in a speech to the Trans-Tasman Business Circle.

He told his audience that New Zealand policy settings were moving a little closer to those of Australia but that "Australia remains more interventionist, less orthodox, than New Zealand". A reasonable interpretation of this claim is that Australia is less committed than New Zealand to monetary and fiscal discipline and an open, competitive economy.

This claim raises two questions: Is it true and is it relevant?

A few years ago the claim might have been defensible. In 1997, the latest year for which the economic freedom ratings of the Fraser Institute are available, New Zealand came in slightly ahead of Australia with an index ranking of 9.1 compared with Australia's 8.6.

Moreover, at that time Australia was still running a fiscal deficit, its inflation rate was unstable, and it was a latecomer to privatisation.

Today the situation is very different.

The Howard government cut government spending substantially, which helped Australia weather the Asian crisis much better than New Zealand. Total government spending is now 32 percent of the Australian economy, well below New Zealand's level of 40 percent. The ratio of government spending to gross domestic product is a key indicator of the extent of government intervention in an economy.

Australia is recording consistent budget surpluses, and its tax system is moving in New Zealand directions with the company tax rate falling to 30 percent, below New Zealand's 33 percent level.

For all practical purposes Australia's monetary policy and inflation performance are now the same as New Zealand's.

Australia has been a major privatiser – asset sales now total A$100 billion – and the process is continuing whereas the government has called a halt to privatisation in New Zealand.

Australia is well ahead of New Zealand in corporatising and introducing private sector participation into infrastructure industries such as roading and water.

Australian and New Zealand tariffs are at similar levels but Australia is continuing to reduce tariffs whereas they have been frozen in New Zealand.

It is well ahead of New Zealand in deregulating and corporatising agricultural marketing boards.

The private sector plays a much greater role in education and health in Australia than in New Zealand, and here the government is reducing private sector competition in education, health and accident insurance. The Australian welfare system is generally more restrictive than ours and New Zealand's is becoming less restrictive.

One area where Australia has been more interventionist than New Zealand in recent years is the labour market. However, New Zealand is re-regulating its labour market while

Australia is slowly freeing its labour market up. If the Employment Relations Bill is passed, New Zealand will lose its edge in this area.

Overall, therefore, Dr Cullen's claim seems difficult to sustain. Australia has taken economic reform further than New Zealand, and is now well ahead of us in the international competitiveness league tables.

Equally important, Australia is continuing to implement reforms – even the defeat of the Kennett government in Victoria has not led to major policy changes – whereas New Zealand is moving backwards. Investors take a forward-looking view in deciding which countries offer the best growth prospects. Trends are as important as the position at any point in time, and New Zealand and Australia are moving in opposite directions.

In any case, is Australia relevant as a benchmark? Australia has not been a standout performer compared with countries such as the United States, Ireland and the more successful Asian countries.

The Howard government's performance has recently been erratic, which has not helped business confidence in Australia at a time when the world economy is growing strongly.

Also Australia has advantages of size and industrial depth that New Zealand lacks. To compensate for these, a small and remote country like New Zealand must have superior, not just comparable, policy settings.

Because Australia has been more consistently reformist than New Zealand, its outlook is now better as a consequence. This was not the case in the mid-1990s.

New Zealand's average annual growth rate for the four years ending 1996, at 4.1 percent, was higher than in any of the Australian states, except the mineral-rich states of Western Australia and Queensland. Since then, New Zealand's growth rate has declined, but growth rates in Victoria, New South Wales, South Australia and even Tasmania have all risen.

Thus, for the four years ending 2000, New Zealand's average annual growth rate of 2.4 percent was substantially lower than the growth rates of all the Australian states except Tasmania.

Some people may try to explain New Zealand's relative growth performance since the mid-1990s in terms of a run of bad luck. However, some of the Australian states have also had their share of bad luck in that period, including drought.

The most obvious piece of bad luck that New Zealand has experienced, and Australia has not, is a series of governments that have slowed the pace of economic reforms – and that have finally put the reform process into reverse.

SOCIETY OF MODEST MEMBERS

THE CHEQUERED PATH OF ECONOMIC REFORM IN AUSTRALIA AND NEW ZEALAND

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

CANBERRA
26 JUNE 2000

THE CHEQUERED PATH OF ECONOMIC REFORM IN AUSTRALIA AND NEW ZEALAND

This is not a good time to be talking in Australia about New Zealand. Although our economy is going through a cyclical upturn and grew by around 4 percent in the last 12 months, business confidence is low, international investment interest has fallen away, and there is a worrying outflow of people from the country. The current account deficit and external debt are at risky levels.

A recent report by a London investment advisory firm assessed the situation bluntly:

> We are switching out of the Kiwi dollar into the Aussie and we're staying out of New Zealand equities and bonds . . .
>
> We don't like the policies of New Zealand's new centre-left government. They are ideologically motivated and represent a significant reversal of the supply-side reforms that made New Zealand excel over the last decade . . .
>
> The opposition National Party seems in disarray . . .
>
> Global capital markets and the advent of the new economy increase competitive pressure on governments to shrink their economic reach and pursue low taxation and business friendly policies . . . No such constraints apply to New Zealand in the mind of the new Labour-Alliance coalition . . .
>
> On our recent New Zealand visit two things stood out. One was the pervasive pessimism of business leaders. The second was that there was not one member of the young elite that didn't want to leave for Australia or other climes offering better career opportunities . . .
>
> Nemesis may take a while. Foreign capital may flow in to buy cheap equities . . . But that's no reason for us to stay long in the NZ$ in an age when the New Zealand government looks set to try and swim back up the river of history.

The New Zealand government rejects that kind of analysis. Although it is a minority government, it persuaded a sufficient number of voters in last November's election that the policies that the Labour government of the 1980s initiated, and which were carried on by the National government of the early 1990s, were somehow 'extreme' and needed to be 'rebalanced'.

This view is, of course, nonsense. None of the so-called 'third way' (yawn) governments, with which our Labour Party likes to compare itself, is swimming against the tide of economic reform of the past two decades. President Clinton has overseen radical welfare reforms never contemplated by the Reagan administration. The Blair government in Britain is largely carrying on the Thatcher government's legacy; while trimming it in a few ways it has extended it in others. Even though continental Europe is still burdened by high taxes and regulation, France's socialist government has implemented more privatisations than its conservative predecessor. Germany is selling shares in its post office and cutting its company tax rate to 25 percent. And so on.

By contrast, since the election, the coalition has increased New Zealand's top tax rate, determined not to reduce the share of government spending in the economy any further, called a halt to privatisation, frozen tariffs, restored the state monopoly in accident insurance, introduced labour legislation to promote the role of unions and collective bargaining, moved to reduce choice and reassert centralised control in education and health, increased the universal state pension and relaxed welfare administration. The deputy prime minister is promoting government-sponsored economic development projects such as a possum fur industry – the invisible hand is being given a possum skin glove. For Australians, the crowning glory in this programme might have been last week's decision to proceed with plans to set up a state bank. No other contemporary government that is part of the Organisation for Economic Cooperation and Development (OECD) is acting to restrict systematically the role and scope of markets in its economy in this way.

As this programme has unfolded, polls suggest many New Zealanders are having second thoughts. On my interpretation, the country was not voting last year for such a radical change of direction; much more it was voting out a tired, incompetent and directionless National Party. Many people in business and indeed in the National Party itself think that the country would have been better off if National had lost office in 1996 – before it went into a coalition with Winston Peters's New Zealand First party.

Government ministers in New Zealand obviously think they are doing the right things, and much of the country still agrees with them, but the movement of mobile capital and labour is sending a clear signal that they have got it wrong. Those with a collectivist mindset talk of a 'capital strike'; they somehow think that investment decisions are coordinated by a capitalist equivalent of a trade union council whereas in fact they simply reflect the judgments of thousands of owners and trustees of capital about relative returns and risks. Young and enterprising people are voting with their feet. A typical example of their attitude is an e-mail I saw recently from a young New Zealander to a friend of hers in the United States:

> In the nicest possible way: DON'T COME HOME! It's a disaster. Margaret Wilson's new employment bill is a shocker and unemployment will be a way of life when it's passed . . . The NZ$ is about US46c and [deputy prime minister] Anderton thinks that is good but interest rates are too high for his liking (the linkage has escaped him again).

Another working in Australia recently wrote:

> I also regret to say that as a young person with aspirations for my future, remaining in New Zealand in the current environment was not a pleasant prospect . . . The international environment is increasingly unforgiving of economies that do not embrace change, innovation, flexibility and other key drivers that have come to characterise successful economies such as the United States and Singapore . . .
>
> Although the direction of the current government plays some role in [my] feeling, it actually goes deeper than that. Watching 'winners' in New Zealand society having their reputations ruined by politicians and the media on the grounds of their success does not send positive signals to my generation, who are generally well educated, hope to succeed, and of course use remuneration as one of the measures of their success.

New Zealand cannot sustain a loss of investment interest and brains for long, or a Tasmanian future will be in store for it. Geographically peripheral economies need to have better policy regimes than those that are at the centre of world markets. Ironically, given the government's alleged concerns, the people who will suffer most if New Zealand does not stand out will not be those who are capable of being citizens of the world but the old, the unskilled and the immobile who will be left behind.

What has gone wrong? Interpretations of the paths that Australia and New Zealand have followed over the past 15 years or so have often been wide of the mark on both sides of the Tasman. Australians have sometimes viewed New Zealand as a model of economic reform and are puzzled as to why it has not done better. Many New Zealanders think that Australia has followed a different path with better results. Both views miss the key similarities and differences.

The reality is that Australia has been a slower but more consistent liberaliser than New Zealand. Australia largely scrapped import licensing in the 1960s, some 20 years before New Zealand. From 1975 to 1985 Australia's economic freedom rating improved (on the Fraser Institute measures, which may overstate the change) from 6.9 to 7.8 whereas, thanks to Muldoonism, New Zealand's rating remained about the same (6.2 in 1985 compared with 6 in 1975). By 1997, the last year for which ratings are available, both countries had moved to a similar score (New Zealand's rating was 9.1 and Australia's 8.6).

But the progress of New Zealand has been like that of a car with a recurrent fuel blockage. It moved ahead rapidly for a while (1984–88) in response to a genuine economic crisis, stalled and then moved forward again for a short period (1991–92). Then it stalled again and is now being put into reverse. By comparison, Australia seems to have been more like a yacht making steady progress despite being carried off course at times by unfavourable winds and currents. Reform in Australia has often been noisy, messy and compromised, but overall Australia has gone further and is staying the course better. New Zealand will pay a high price for its failure to achieve a sound and stable 'economic constitution', as a recent monograph by Wolfgang Kasper for the Centre for Independent Studies points out. By the time of the next election in 2002, New Zealand looks likely to have suffered a decade of lost opportunities.

Other indicators confirm this picture. Having achieved a high ranking in the international competitiveness league tables (ninth position in 1995, well ahead of Australia in twenty-first place), New Zealand fell to twenty-first position in the latest survey while Australia moved up to thirteenth place). The two countries' positions on the economic freedom index must surely soon be reversed also. To take one key indicator of economic freedom, Australia has reduced spending by governments at all levels from 35 percent of gross domestic product (GDP) in 1994 to around 32 percent, according to OECD figures. In New Zealand total government spending is much higher at 40 percent of GDP, the same ratio as in 1994.

Both countries have lifted their economic performance. The OECD has assessed that as a result of economic reforms, New Zealand's economic growth potential has risen to around 3 percent per annum, about double what the economy was capable of sustaining during the 1970s and 1980s. Work by the Australian Productivity Commission suggests that the rate of productivity growth in Australia since 1993/94 has been double its previous average. It is unlikely that this surge in productivity would have occurred without reform. But as a result of New Zealand's policy slippage since the early 1990s, Australia has been doing better than New Zealand in recent years, contrary to the situation only five or so years ago when there was talk of the New Zealand dollar achieving parity with the Australian. The performance gap between the two countries now seems likely to widen in Australia's favour.

Given the present malaise in New Zealand, it would be nice to think that Australia was continuing to add to its achievements and to provide a beacon of light for New Zealand. In some ways it still is: Australia is about to implement major tax reforms (although the compromises over the goods and services tax are regrettable); some states are progressing with electricity, port and rail privatisation; Australia is well ahead in establishing commercial water and roading operations; and deregulation of agricultural marketing is further advanced.

However, in other respects, Australia seems to be catching the New Zealand disease. It is baffling to understand how a government that came into power after so long in the wilderness, during which time it replenished its intellectual capital and cast off the failed practices and policies of the Fraser years, should have retreated so far and so quickly into the bunker and abandoned a reform agenda.

At least from 2000 kilometres away it has been painful to watch John Howard snuggling up to Chesty Bond, the abject capitulation to the carmakers, the overly complicated workplace reform, and the jettisoning of David Kemp's sensible tertiary education policy and Jocelyn Newman's overdue welfare proposals – in the last two cases at the first whiff of media grapeshot. Having stared down Pauline Hanson much more effectively than our politicians dealt with Winston Peters, the government now seems to be developing a myriad of spending programmes for every squeaky wheel in regional Australia. These programmes can do little to moderate the fundamental economic forces to which regional economies must adjust, and will surely end up being another cruel hoax. Australia now seems to be behaving uncritically on greenhouse policy as though it is some deep-green Scandinavian country. And, when one hears talk that the new priority is social policy not the economy, there is a temptation to shout across the Tasman: "It's the economy, stupid!". Might Australia see a government that appears to be losing its way be replaced by a backward-looking opposition, and throw away hard-won economic gains? The New Zealand parallels seem stark.

Why have New Zealand and Australia caught these diseases to varying degrees, and how can we throw them off? It is easy to find excuses. In some respects political institutions in both countries do not help; the adoption of the Mixed Member Proportional electoral system in New Zealand has conferred on us some of the 'blessings' of the Australian senate. The downfall of reformist governments can be a blow to confidence, although arguably the Kennett defeat owed less to voter disagreement with overall policy directions than to a number of dubious projects and the way an otherwise admirable premier treated many critics or doubters as fools.

Then there is the excuse of reform fatigue. But, there does not seem to be much evidence that large numbers of people have decided to resist reform as a result of careful consideration of the issues. Not many people are prepared to argue that stopping reform would result in higher living standards. Most people want improvement in their lives, and improvement requires change. Australians and New Zealanders are fast adopters of new technologies like computers, mobile phones and the internet because they see the benefits of them, even though they bring profound changes to workplaces and lifestyles. Why should they not support changes to policies and institutions if the benefits are explained fully, simply and intelligently?

Perhaps therein lies the rub. Towards the end of his term as chairman of the Australian Industry Commission, Bill Scales observed:

> As I travel around the policy forums of this country I am struck by the degree of backwardness in many of the arguments that I hear. Arguments that were fought and lost in the 1970s are appearing again. And the level of understanding that characterised earlier debate seems to have fallen away.

The patron saint of this Society was Bert Kelly, whose efforts over many years were a supreme example of the power of one person in demolishing false ideas and promoting better ones. When Bert began his career, free trade was a despised heresy; today it enjoys widespread support. On the other side of Australian politics Peter Walsh performed a similar role. Where are the Kellys and Walshes today when we need them? In New Zealand in recent years we have had no politicians and few media commentators who have challenged the country to build on its partial reforming success and who have warned of the risks of stalling or going into reverse.

In the end it all comes down to public understanding. Politicians are society's leaders and communicators. They must address the things that concern people, explain why they are happening, and persuade them of the best responses. Regional Australia and New Zealand will decline more rapidly if we protect industries in our cities, make our labour markets less flexible and fail to achieve high levels of international competitiveness. New technology and globalisation are putting a premium on skills and stretching the income gaps that worry the community, but if we focus on inequalities rather than on helping the poor and if we set our face against such trends, everyone will be worse off, especially those people on low incomes. We either adjust or we fall further behind leading countries.

If battles like these are not fought and won, politicians will allow a perception to develop that compassionate policies are at odds with 'economic rationalism', which is not only wrong but will make the task of future reform harder. Politicians must make the case for personal advancement through initiative and hard work in a society that provides opportunities, as opposed to one with an anti-success culture and a focus on redistribution. The only place where success comes before work is in the dictionary.

In taking the high road, reform-minded politicians ought to be able to expect support from business. Politicians like Bert Kelly and Roger Douglas did much to wean business away from state privileges and enjoin their support for free trade and open markets. But the lessons have to be taught anew in each generation.

In both countries today we are hearing nonsense about trade reciprocity. Industry minister Nick Minchin deserves praise for the stand he took against interventionist policies at the Melbourne Innovation Summit. Simon Crean seems to be picking up New Zealand's current reactionary ideas about labour market policies. In the debilitating environment in New Zealand some people in industry are calling for subsidies like research and development (R & D) tax concessions and some in farming are calling for regional handouts and subsidised telecommunication services. Other business leaders have fortunately not succumbed to such temptations. They have continued to resist more interventionist policies and defended the open and competitive economy that has benefited consumers by forcing businesses to meet their needs. In a bizarre turn of events, however, such business voices are being painted as self-serving and as a constituency that has nothing to do with the creation of jobs and the incomes of ordinary people. Politicians and business people must work together to counter such confusion.

In the final analysis, politicians can face the inescapable challenges of economic change in two ways. One way is to say to the electorate: "We understand your concern that change might be disruptive, so we will not introduce further reforms and indeed we will roll back some existing ones". The alternative is to say something like: "The future prosperity of people in this country depends on how we adjust, individually and collectively, to changes in the international economic environment. We therefore propose to carry on doing things that will let individuals and firms take better advantage of the opportunities in the world around us".

The choice between these approaches may appear to be a choice between greater security on the one hand and greater prosperity on the other. In reality it is nothing of the sort. There are huge risks in attempting to preserve the status quo in a rapidly changing world. Either we accept the challenges and rewards of steady, continuous change or we face relative national decline and ultimately serious economic and social crisis.

Those of us who value freedom, prosperity and security thus have no choice but to continue to make the case for continuous policy improvement. In recent years the going has become much tougher in Australia and New Zealand. But we should recall that for most of his time in parliament Bert Kelly fought pretty lonely battles, and it may take time for liberal ideas to get a better hearing again.

Certainly we must hope for a turn of fortune. Around the world liberal ideas are continuing to spread. Against all international experience, it is just not credible to believe that the current trends towards more intrusive and over-stretched government in New Zealand will make it a more prosperous and fairer place. We may have to learn some hard lessons all over again before the electorate recognises that success in the modern world requires smaller, better government and greater personal and economic freedom and responsibility. It would be a further setback for us if supporters of the cause of reform and the ideas of Bert Kelly failed to carry on defending them in Australia.

EMPLOYERS AND MANUFACTURERS ASSOCIATION
BUSINESS ENVIRONMENT 2000
'THE VISION'

A POSITIVE AGENDA FOR THE BUSINESS SECTOR

RALPH NORRIS
CHAIRMAN
NEW ZEALAND BUSINESS ROUNDTABLE

AUCKLAND
16 MARCH 2000

A POSITIVE AGENDA FOR THE BUSINESS SECTOR

It is a commonplace nowadays for businesses in New Zealand to be benchmarking themselves against leading firms in their industries in other parts of the world. We have to aspire to international best practice if we want continuous improvements in living standards. Many New Zealand businesses are operating in an increasingly open world economy and they must match the cost savings and innovations of their competitors if they are to survive.

Similarly, New Zealand must benchmark its economic policy environment against that of leading nations. A remote country with inherent natural disadvantages must do everything in its power to offset them by adopting policies that are attractive to internationally mobile capital, people and businesses.

One of the penalties of distance is that the public is not always fully aware of developments in the rest of the world. This was a serious problem in the decades when New Zealand became an increasingly inward-looking economy. It took interventionist policies to a level not found in any other advanced country, and suffered a drastic decline in relative living standards. There is much more involvement now with the outside world, especially by younger people, but the country is often still slow to recognise and adopt important ideas and trends.

It is true that over the past 15 years we have learned some of the lessons of international economic success. The minister of finance, Dr Cullen, acknowledged recently in a *New Zealand Herald* article that the moves to free up the economy were not "an experiment", as many have claimed. Economic liberalisation is in fact a mainstream development common to all the Organisation for Economic Cooperation and Development (OECD) countries without exception, and many others as well. In a study for the New Zealand Business Roundtable, David Henderson, a former senior OECD official, pointed out that, contrary to a widely held view, liberalisation does not represent a victory for conservative or right-wing ideas and principles. Historically, and in the modern era, economic liberalism rather than interventionism has been espoused by parties of the left and right alike, in the interests of creating an entrepreneurial and dynamic business climate. Thus, there is no reason in principle why a centre-left government should be negative for business.

To date, however, the thrust of the coalition government's policies is running counter to international trends. I cannot think of any other country with a programme that includes moves to raise the marginal tax rate, re-nationalise accident insurance, halt privatisation, reduce competition in health and education and re-regulate the labour market. The deputy prime minister, Mr Anderton, has declared that "the free market policies of the last century failed". Most politicians around the world would say that the major sources of failure last century were socialism and big government. It is clear that we have some way to go to establish a consensus on what constitutes sound policies.

So I thought it would be useful to reflect on what has happened and is still going on around the world, and on the international lessons of success. Often we hear it said that "the pendulum has swung too far" in this country. But it is hard to see where New Zealand is out on a limb today in relation to other countries, and I see few signs that other countries are changing their basic directions, regardless of the political parties in office.

My reason for taking this approach is that it is simply not good enough for the business community to criticise government decisions that it thinks are mistaken. The Business Community should also be promoting a positive agenda for New Zealand. Many of us in business felt that New Zealand governments lost their way during the last two parliamentary terms, and that New Zealand's economic performance has suffered as a result. We have no interest in defending the results of recent mismanagement. Rather, the concern of the business sector should be to highlight the costs of recent policy drift, to alert the public to further policy mistakes and to promote policies for better performance, drawing on international experience.

In looking at developments around the world, I do not wish to suggest that policies adopted by other countries necessarily make sense for New Zealand. The laws of economics are pretty general, but there are always local factors that need to be taken into account. Moreover, there are no perfect models; no country has solved all its problems. Indeed there are plenty of examples of bad policies around the world, even in relatively successful countries. It would make no sense for New Zealand to engage in agricultural subsidies just because the European Union and other countries do. The same argument applies to interventionist industry policies that many countries engage in. Policies should be framed in the first instance on the basis of sound economics. But it is always useful to look for evidence internationally as to what works and what does not, and to observe the directions that successful countries are following as they respond to changes in economic thinking and practical experience.

There is no doubt that the economic landscape has changed remarkably in the past 20 years. In the 1970s, Keynesian economics was the influence behind monetary and fiscal fine-tuning in many countries. Income policies were commonplace. Many industries were heavily regulated. Welfare states were expanding. Both the government sector's share of national income and tax rates were on the increase. There was extensive nationalisation of industries.

In response to the inflation and slow growth of the 1970s, there has been a turnaround in economic thinking and practice. Twenty years later it is hard to remember some of the debates and reactions as governments of the day sought to change direction. Today, the consensus in favour of stable macroeconomic policies, open markets and smaller government is continuing to strengthen.

Consider first the United States. It is entering the twenty-first century unchallenged in terms of technological innovation, job creation, and success in reversing welfare dependency, crime and other social indicators. In the Reagan years, however, there was much talk of policies leading to de-industrialisation, a 'hamburger-flipping economy', 'short-termism' on the part of capital markets, and an obsession with 'the quarterly dividend'. Many critics saw the United States losing its industrial supremacy to Japan and advocated Japanese-style 'industrial policies'. As late as 1992, economist J K Galbraith stated that:

> [US] competitive strengths are no longer great enough to support our living standards at full employment.

Today those voices are largely silent. The United States is operating at close to full employment and the painful economic restructuring and wage stagnation of the 1980s have been succeeded by rising living standards for all groups, including the poorest. In the five years to 1998, real incomes for the lowest 20 percent of families rose at an average rate of 2.7 percent a year, according to the US Council of Economic Advisers.

To all intents and purposes, the Clinton administration took over where previous Republican administrations left off. President Clinton shifted the Democratic Party in a pro-business, pro-free trade direction. He went beyond Reagan in tackling welfare reform. He embraced the notion of a balanced budget. During Mr Clinton's administrations federal spending has fallen as a percentage of the US economy from 22 percent to 18.3 percent. Total government spending in the United States has fallen by a similar amount – to 32.3 percent in 1999 compared with 41.5 percent in New Zealand, according to the OECD.

Much the same thing has happened in Britain. In opposition, Tony Blair confronted the backward-looking elements in the Labour Party, and in office he has essentially maintained the thrust of previous Conservative government policies. Only minor changes were made to the labour reforms of the Thatcher government, and Mr Blair has done things like making the central bank independent and introducing tertiary fees that Mrs Thatcher would not have contemplated. The government is now planning to privatise the commercial arm of the British Broadcasting Corporation (BBC). The payoff for Britain, from 20 years of reforms is one of the strongest economies in Europe. A threat for the future might be an upward creep in government spending under Labour, after a disciplined start.

In continental Europe, where problems of unemployment and welfare dependency have remained more entrenched, attitudes towards Anglo-Saxon capitalism appear to be changing. As *The Economist* wrote in a leader in February:

> To a surprising extent, especially when measured against what politicians say, Western Europe's parties of the left, many of them now in power, are moving away from their traditional statist dogmatism towards a pragmatic, if reluctant, recognition of unavoidable economic facts . . . People are voting for lower taxes, less public spending, a lighter hand of regulation: that is why hitherto leftist governments have made a start on delivering them.

Besides Britain, the Netherlands, Denmark and Ireland have moved away from European-style, heavily regulated labour markets and are reaping the rewards with increased job creation and investment. All European governments, including even France under a socialist government, are continuing with privatisation programmes. Company tax rates are falling. There is a move from fuzzy notions of stakeholder capitalism to a focus on shareholder interests, most dramatically illustrated by the recent Vodaphone-Mannesmann takeover. "Germany as a closed system . . . is over", its finance minister told the recent Davos economic summit.

Closer to home, the strong performance of the Australian economy is routinely attributed to 15 years of steady economic reform. We are often told that Australia has done things differently from New Zealand. The balance sheet of changes in Australia now includes financial market deregulation and the floating of the exchange rate; a reduction in effective manufacturing protection from around 35 percent to around 5 percent; an independent monetary policy targeted at low inflation; sustained fiscal surpluses and a lower ratio of government spending to gross domestic product (GDP); reforms in utility industries including corporatisation and privatisation; deregulation of telecommunications, electricity and agricultural marketing; labour market deregulation; public sector reform; the introduction now of a goods and services tax and a planned lowering of the company tax rate to 30 percent. Does this sound like a different programme from New Zealand's? I do not think so.

It is sobering to reflect on how commentators in Australia are now viewing New Zealand. The deputy editor of the *Australian Financial Review* wrote in a recent article:

> [New Zealand] is no longer a leader . . . the centre of industrial and financial reform as it was throughout much of the 1980s. Reform is not even on the agenda . . . For Australian investors, the most likely source of concern for Australian corporates who do business in New Zealand are Labour's plans to restore unions to the central role in collective bargaining.

Australian governments at both federal and state levels are generally trying to make more progress with privatisation and with reforms to labour markets, tariffs, education, health and welfare. In some cases they are struggling, and there have been some populist reactions and backsliding. But the overwhelming message from business in Australia is: "don't stop the reform process now".

Finally, in Asia the picture is of a rapid rebound from the 1997–98 crisis as governments stuck with open market policies, addressed problems in banking systems and corporate governance, and backed off some of the interventionist industry policies that contributed to their undoing. From China to India, there is a steady, continuing push towards economic liberalisation, and the same is true of several countries in Latin America and in South Africa. A question mark still hangs over Japan, where the huge growth in government expenditure, taxation and debt over the past 30 years and heavy regulation of many sectors are holding the economy back.

All in all, this is a picture that seems to have clear implications for New Zealand or any other country that wants to succeed in the modern world. The message is reinforced for New Zealand by the OECD, by no means a radical organisation but one that broadly reflects the consensus views of its member governments. In its recent reports on New Zealand the OECD has stressed the need to pursue an ongoing reform programme, not the "stop-and-go reform effort" of recent years. It has criticised the blow-out in government spending, urged a resumption of the "largely stalled" programme of privatisation, argued for bulk funding of schools and more competition in health and education, recommended changes to personal grievances provisions and the Employment Court, and proposed limitations to superannuation and welfare benefits. All these recommendations are in line with actions being taken elsewhere but run counter to current directions in New Zealand. There is no talk in OECD circles of a case for more 'hands-on' policies.

Against this background it is hard to see the basis for Mr Anderton's claims that liberal economic policies have failed. One of the most clear-cut conclusions of economic research in the past 20 years is the positive relationship between economic freedom and growth. As *The Economist* summarised it recently:

> The conclusion is abundantly clear: the freer the economy, the higher the growth and the richer the people. Countries that have maintained a fairly free economy for many years did especially well.

Governments have an important role to play in setting a clear and predictable macroeconomic and regulatory climate, protecting property rights, enforcing the law, avoiding inflation, underwriting access to health and education and providing a social safety net. Beyond that, however, they should make maximum room for individual initiative and business enterprise.

I believe that the business community must keep the liberal reform agenda before the public. There is no evidence that the course that the government is embarking on will make New Zealand more prosperous or create a fairer society. The business community, the media and opposition parties need to press the government to justify its actions by reference to accepted economic thinking and evidence of success elsewhere. There is no need for this to be a confrontational process, but it is perfectly reasonable to expect explanations and evidence.

It is not, for example, sufficient for the government merely to claim that it has an election mandate to implement particular policies. Sir Robert Muldoon could make the same claim, but his policies nearly bankrupted the country. Surveys and submissions on the accident compensation (ACC) legislation indicated that there was majority opposition to the changes. There is no obvious majority in support of repealing the Employment Contracts Act 1991. Governments in office have far more information than parties in opposition and have a duty to listen to advice and reconsider unwise plans. The belief that majorities are always right has led to disastrous policies, and to a disregard of the views and rights of minorities that has no place in a democracy.

The government has said it wants a dialogue with the business community, but a constructive dialogue must involve a willingness to take on board business concerns. Many people in business are finding it difficult to understand how the policies the government is actually following will help achieve its targets for economic growth and employment. Overseas observers are struggling to make sense of New Zealand's directions. To the prime minister's claim that there is "no relationship" between tax rates and growth, a *Wall Street Journal Europe* editorial response was, "Where has she been looking?". Major international investors have been quietly reducing their exposure to New Zealand. Its policy environment is not compensating for the natural difficulties of doing business in a small, remote economy.

Business leaders who are concerned about New Zealand's future must, therefore, tell it as they see it. If they believe current moves will produce bad outcomes, there is no point being wise after the event. They can take confidence from the lessons of successful policies elsewhere, and from the benefits that economic reforms were delivering in New Zealand in the early 1990s before a consistent policy framework was allowed to unravel. Whether or not politicians heed such messages in the short term, the business sector must keep in front of the public a positive agenda for New Zealand.

ROTARY CLUB OF PALMERSTON NORTH

MYTHS ABOUT ECONOMIC REFORM

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

PALMERSTON NORTH
13 SEPTEMBER 2000

MYTHS ABOUT ECONOMIC REFORM

Earlier this year, the chairman of the Productivity Commission in Australia, Gary Banks, gave a talk about economic reform that contained striking parallels to many of the debates in New Zealand. The Productivity Commission is the Australian government's leading research agency on a wide range of economic policy issues, and its studies and reports (and those of its predecessor bodies, the Industries Assistance Commission and the Industry Commission) have influenced many of the economic reforms in Australia over the past 25 years.

Gary Banks began by saying that the history of economic reform in Australia indicated that worthwhile policy changes had rarely been easy to achieve. Reforms that were in the enduring interests of the community as a whole inevitably imposed adjustment costs on some of its members. They also threatened established privileges and perceived entitlements, some of long standing. Vocal opposition from those who benefited from the status quo, together with a more general fear of change itself, were powerful forces of resistance. As a result, Mr Banks said:

> We face a critical conjuncture. Ironically, at a time when evidence of the pay-offs from past reform efforts is mounting – and when, as we grapple with the aftershocks of the Asian 'meltdown', the importance of securing a stronger and more flexible economy has never been more obvious – there is a mood to stop or turn back the clock, rather than build on our achievements. . . . While resistance to change is understandable, the consequence of stopping or reversing reforms necessary to enhance Australia's productivity would be a progressive decline in the relative living standards of Australians. In a changing world, it is only by being adaptable and productive that Australians can achieve real security in their workplaces and regions.

The challenges to reform in Australia that Gary Banks listed include concerns about jobs and job security, the decline of services in rural areas and the perception that the reforms have meant 'all pain and no gain' for ordinary Australians. He argued that if nationally beneficial reforms were to proceed, these concerns and criticisms needed to be met head on. Compounding the problem were misunderstandings and myths about the nature of economic reform. Five myths that he listed are worth discussing because they are often heard in New Zealand. Answering these myths is a task confronting all proponents of policy reforms worldwide.

Myth # 1 Stopping reform would ease pressures for change

It is often claimed that no more economic reform should take place because people are tired of change. Frequently there is confusion between changes genuinely associated with policy reforms and the many other changes that are happening all the time. For instance, changes in social attitudes are always occurring, which politicians have limited power to influence. The past generation has seen important changes in the roles of women. There are also demographic changes such as the ageing of our population. Many technological innovations bring major social change. The recent revolution in communications technology and computing is transforming workplaces. Like almost all technological advances since the beginning of the industrial revolution, the information revolution has, on balance, been beneficial. But it has also seen the demise of typing pools and routine clerical functions, and forced people to upgrade their skills.

Some countries have experienced a trend to a more unequal distribution of income in recent years. Critics of the market have been quick to blame economic liberalisation. Yet the evidence for these claims is typically sparse or non-existent. Studies have found that the major factor is technological change favouring skilled labour over unskilled. But there is nothing inevitable about this trend; technological change can have the opposite effect on income distribution. The innovations of the next generation could well favour unskilled labour over skilled. For instance, there might come a day when a computer programme can largely replace certain medical and legal procedures, yet constructing a robot that can perform housework satisfactorily still proves to be elusive.

Change is necessary if there is to be any economic progress at all. Most people want improvement in their lives, and improvement requires continuing change. Moreover, no government, simply through heavy regulation or control, can ensure that change occurs at some predetermined rate or that all bad effects can be avoided. By resisting many necessary changes prior to 1984 we built up a backlog of adjustment, and change was inevitably more traumatic when it happened. Change and risk will always be with us; it is a question of devising institutions that enable us to handle them well. Thus, when New Zealand had a fixed exchange rate regime, uncertainty was not eliminated in the foreign exchange market. As the rate was pegged to a basket, individual currencies were volatile. Moreover, no pegged rate is fixed for ever, and under the previous system business people were faced with periodic, large devaluations that were difficult to anticipate and inevitably disruptive. Those good at predicting the whims of politicians did well, while others were punished. The move to a freely floating exchange rate did not increase overall risks. Rather it made them more transparent and easier to manage.

Myth #2 Reformers have unlimited faith in 'the market'

This assertion merely sets up a straw man for easy demolition. Gordon McLauchlan is an example of a journalist willing to attribute quite absurd views to proponents of reform. In one of his many flights of fancy, he once wrote that I want New Zealanders to believe that "business not only brings us our dinner but our laughter, our love, our dreams, our soul's imaginings". Confronted with drivel of that sort, rational debate becomes impossible.

Economic reform does not involve slavish adherence to market forces. Competition, deregulation and privatisation are legitimate tools in the reform armoury, and they have yielded large benefits. But they are not ends in themselves and they are not relevant in all circumstances.

In reality, many limitations of the market are acknowledged openly by reformers. They understand the key role played by government in supporting markets through providing a sound legal framework. They also understand that the government must finance the provision of so-called public goods – those goods that would be under-supplied by the market. Hardly anybody would deny that the government has a role in public health, national defence or the policing of our streets, to name just three key public goods. No one wants a market for core police services.

The government also has an important role in maintaining a social safety net for those in genuine need. There is much to debate about the nature of that safety net – about its level, whether assistance should be in the form of cash transfers or of specific services, and who should be eligible to receive them. But the need for a state safety net of last resort – if the resources of personal savings and insurance, family support and help from the voluntary sector prove inadequate – is accepted by most people. Reformers are also aware that a market economy depends crucially on a wider civil society that is strong and supportive. Markets operate best when there is a culture of trust, honesty, respect for others, and good faith dealing. Such a culture cannot be created overnight by government, as reformers in Russia have discovered to their dismay. Where it is lacking, markets will be characterised by short-termism, fraud, fly-by-night operations and, at worst, gangster capitalism. Ultimately the strength of our civil society depends, not on government, but on decisions made by all of us as individuals, and as members of the groups to which we belong. A market economy must be built from the bottom up.

Myth #3 Microeconomic reform is bean counting

Governments are always being accused of penny-pinching by some interest groups, as well as being criticised for using taxpayers' money extravagantly. We hear claims by public sector unions and others that education and health are 'under-resourced', despite very large increases in spending in these areas in recent years. Welfare spending is a higher fraction of national income today than it was in 1984. Experience suggests that the focus of attention should be less on the amounts spent and more on the poor performance of dysfunctional systems.

Many reforms within the New Zealand public sector – such as direct resourcing in schools or the separation of funding and provision in health – are aimed at getting better value for the taxpayer's dollar. Those reforms in the social areas, however, have been partial in nature and only half-heartedly implemented, and it is not surprising that the community remains dissatisfied with these services. This represents a failure of political nerve as much as a lack of public policy understanding. It reflects the success of organisations like the Post Primary Teachers' Association (PPTA) and the Coalition for Public Health in clouding issues in the public mind.

Often good microeconomic reform has a positive impact on the government's budget, such as when subsidies to exporters were abolished in New Zealand. But sometimes it has had the opposite fiscal effect, as when tariffs have been cut. And it is easy to name existing New Zealand statutes where the purpose of the legislators would be better served by an explicit subsidy than by regulation. For instance, if the government were genuinely concerned about the employment prospects of people with disabilities, a direct subsidy to employers willing to hire them would achieve its objective far more effectively and transparently than the Human Rights Act 1993 – a statute that is wrongheaded and counterproductive because it denies freedom of association and contract in employment.

Usually the debates over microeconomic issues are not about limiting some total aggregate of money. More often they are about who is best placed to make decisions over how much money to spend. For instance, from the time of a 1987 report the New Zealand Business Roundtable urged the abandonment of the government's ill-considered involvement in accident insurance. By creating an effective government monopoly, the architects of our accident compensation scheme ensured that accident insurance was inefficiently produced, and that consumer choice was seriously curtailed. The partial opening up of the scheme to competition already appears to be producing annual cost savings of the order of 30 percent for many employers. I do not know how much the average New Zealander would choose to spend on accident insurance if the government deregulated the market fully and ceased operating as an insurer. Nor does Murray McCully or anybody else. And that is my point: purchasing accident insurance is a decision better left to individuals and families than imposed by a one-size-fits-all government scheme.

None of this is to deny, of course, that the aggregate level of government spending is important. The Business Roundtable believes that government spending in New Zealand is currently far too high, and that the tax burden required to finance this spending is seriously hampering economic growth. If the government were limited to its proper role of financing public goods and a social safety net, spending could be brought down to below 20 percent of gross domestic product (GDP). Rather than taxing middle-income New Zealanders so steeply, and then returning their money in the form of 'free' but inefficient health and education services, it would be far more logical for the government to restrict subsidies for these services to the lowest income groups. Elimination of all the 'churning' in social spending would enable tax rates to be brought down substantially. So too would stricter reciprocal obligations on a number of welfare benefits.

Myth #4 Microeconomic reform is without social conscience

One popular claim is that reformers are only concerned about dollars and cents, not people. Ironically, proponents of this myth are often associated with organisations demanding quite explicit quantities of dollars and cents from the government, although they rarely spot the irony. Equally, they express concern about poverty, yet the key feature of poverty that they are usually concerned about is the lack of higher money incomes.

In a recent article, the Australian journalist and author Paul Kelly speaks of:

> . . . the biggest and most dangerous myth in our current political dialogue – that economic efficiency leading to economic progress, and social inclusion leading to a more caring and tolerant society, are incompatible. This assumption has almost become an article of faith in some quarters. The slogan is entrenched – if you believe in the market, you don't believe in society. It is damaging because it is false and its consequence is to weaken economic liberalism or social inclusion or both.

It is often forgotten that economics is a *social* science. Economic policy is all about people and their wants. And it is hard to see how delivering higher incomes to people ranks as an exercise without social conscience. Permanently higher incomes are achieved only through increasing productivity, which is what economic reforms are all about. Higher incomes enable people to consume more of those goods and services that are important to them. Such goods and services obviously include health, education, the arts, environmental goods, religious and charitable activities and all those other activities that opponents of reform typically claim are neglected under economic liberalisation.

Moreover, societies cannot share what they do not produce. By generating higher levels of national income, reforms aimed at improving the productivity of the economy provide the wherewithal to fund the access and equity objectives of governments in education, health and other key services. We do not see world class social services in poor, unproductive countries, no matter how 'free' to the consumer those goods may be. Even Ken Douglas, once a conspicuous client of the Soviet health system, has not been heard promoting it recently. Richer countries also typically have cleaner environments.

Myth #5 Reform has not delivered

This myth evaporates as soon as we compare the New Zealand economy in 1984 with today. Since a more coherent economic framework was put in place in the early 1990s, the economy has averaged around 3 percent annual growth and both independent and government forecasters expect growth of around 3 percent for New Zealand over the next few years. That is far better than we achieved in the decade to 1984. Over that period Sir Robert Muldoon borrowed his way into the history books. The economy was stagnant and living standards were artificially inflated by borrowed money. If Roger Douglas had not stepped in, the International Monetary Fund (IMF) would eventually have done so and with far more drastic medicine. The pain suffered by New Zealanders in some of the early years of reform was real enough. It was partly unavoidable and partly due to some key reforms being delayed far too long. But it is incontestable that the economy is now stronger, and that the capacity of New Zealanders to increase their incomes over time has been boosted.

However, it is equally clear that New Zealand could be doing much better. Since the second 'wave' of reforms associated with Ruth Richardson's tenure as finance minister, there has been a step back for every step forward. In recent years a raft of badly conceived initiatives have substantially increased government spending, especially the fiscal 'great leap backward' in the form of the $5 billion of new spending in the National-New Zealand First coalition agreement (only reduced slightly in response to the Asian crisis). This has drained resources from the private sector, eliminated the budget surpluses, reduced national savings and contributed to a precarious balance of payments position.

Microeconomic reform has been similarly haphazard and intermittent. Consider producer board reform. Two years ago Lockwood Smith, as minister of agriculture, was ridiculing the Business Roundtable's arguments on this issue and instructing his officials to do no more work on it. Last year, after a budget announcement on reform promoted by New Zealand First, the prime minister pulled the rug out from under the feet of Lockwood Smith's successor, John Luxton, when the coalition broke up. Now, Sir William Birch is heralding producer board reform as the government's major initiative in this parliamentary term, even though the proposals for the dairy industry fall well short of what would be best for the economy and export monopolies for kiwifruit and apples and pears are to stay in place indefinitely.

Similarly, there have been some privatisations, but we are trailing well behind countries like Australia in sectors such as electricity which is crying out for private ownership as a means of rationalising the industry. Instead, price controls on electricity lines companies are promoted by the government – a shallow and short-term fix. To the astonishment of government officials, the prime minister told a recent local government conference that the government was abandoning its plans to lead reform of the water industry and was handing the job over to local government instead – the very sector that has been responsible for the industry's chronic under-performance. After the enormous advance of the Employment Contracts Act 1991, the creeping re-regulation of the labour market by the Employment Court continues, and our unemployment rate remains a standing indictment of government policy. No wonder so many of the fundamentals of the New Zealand economy have deteriorated since the early 1990s. Surveys of international competitiveness show us slipping down the world rankings at an embarrassing rate. Nobody except Winston Peters was surprised when our international credit rating was downgraded last year.

Numerous other myths about reform could be added to the list I have given. They would include the myth that, though the reform programme was needed initially, all the necessary changes have now been made. In areas such as privatisation, deregulation and the introduction of the private sector into infrastructure provision, other countries are making faster progress. Gary Banks remarked that when it comes to reforms to improve the performance of Australia's social infrastructure – its schools, hospitals and community services – Australia has hardly begun to scratch the surface, and the same could be said of New Zealand. Are we supposed to change the subject when anyone is obtuse enough to bring up our adult illiteracy statistics, or the hundreds of thousands of New Zealanders on welfare benefits. It takes an impressive suspension of the critical faculties to buy the line that no more reform is needed. Yet the government has not tackled the problems with any vigour, and many of the policies advocated by the opposition parties vary from the mildly harmful to the truly frightening.

In sum, while New Zealand has come a long way, there is too much at stake for us to become complacent or, worse, to attempt to turn back the clock. At present, political parties are clearly reacting to what they perceive to be elements of public opinion that want the world to stop or to revert to failed past policies. The comments of Gary Banks indicate that the issues and debates are no different in Australia, and nor are they in other countries, but some are coping with them much better than we are.

I believe we are in this dilemma because governments from the early 1990s have failed to tell the public that New Zealand has much work to do to achieve its full potential. Neither the government nor important parts of the media have been explaining that the maintaining of international competitiveness and the raising of living standards are processes that have no end. Organisations like the Business Roundtable that point out these realities are regarded as delivering a tiresome message. Many commercial and professional people are deciding that it is easier and more rewarding to do business elsewhere.

If New Zealand wants to avoid becoming another Tasmania with falling relative living standards and an outflow of its most talented people, it needs to wake up. Greater community understanding and acceptance of the need for continuous policy improvement are pre-conditions for further progress. Allowing myths about economic reform to persist is a recipe for continuing paralysis. I hope I have made a contribution to dispelling some of them today.

FISCAL POLICY AND THE PUBLIC SECTOR

LOCAL GOVERNMENT FORUM

SUBMISSION ON AUCKLAND CITY COUNCIL'S DRAFT 2000/2001 ANNUAL PLAN

MAY 2000

AUCKLAND CITY COUNCIL'S
DRAFT 2000/2001 ANNUAL PLAN

1 Overview

1.1 This submission on Auckland City Council's draft 2000/01 annual plan (the Plan) is made by the Local Government Forum (the Forum). The Forum comprises business organisations that have a vital interest in local government (details are attached). The members of those organisations are among the largest ratepayers in Auckland City.

1.2 The Plan proposes an increase in rates of 1.8 percent. Any rate rise is unacceptable. The major contribution that the Auckland City Council (the Council) can make to growth and employment prospects in Auckland is to reduce the rates and regulatory burdens it is imposing on the private sector. The Council could achieve a rapid reduction in rating burdens by focusing on its core activities and funding them fairly and efficiently. Some options for moving in this direction are listed below.

1.3 While the Forum supports the proposal to take a further step in reducing differential rates, the Council should put in place a planned programme to phase them out. There is no economic or financial justification for imposing a disproportionate rating burden on the business sector. User charges should be applied where appropriate, and remaining revenue requirements should be met by a uniform levy on rateable property with no discrimination between residential and non-residential ratepayers.

1.4 The balance of this submission is presented in four sections. The next section (section 2) reviews the Council's spending and revenue. Section 3 examines the proposed rate increase. Proposals to cut spending are outlined in section 4. Section 5 contains comments on the quality of information presented in the Plan.

2 Forecast spending and revenue

2.1 The financial performance of the Council is summarised in the table below. It shows the outturn for 1998/99, the budget and forecast outturns for 1999/00, and the budget for 2000/01. The table has been prepared on a group basis (ie including Metrowater) but the Auckland Regional Council (ARC) levy has been eliminated to reflect the Council's activities more accurately. In addition, activities funded from the designated fund reserve have been included in spending on activities, which is the appropriate treatment. Additional depreciation that was provided separately in 1998/99 has been included in the cost of activities. Thus, the change in the policy on depreciation does not distort the analysis presented. The cost of activities is shown gross of external revenue.

Spending, revenue and operating surplus group basis excluding ARC levy

	1998/99 Actual	1999/00 Budget	1999/00 Forecast	2000/01 Budget	1999/00 Forecast Budget Variance	2000/01 Increase Over 1999/00 Forecast	2000/01 Increase Over 1999/00 Budget
	$000	$000	$000	$000	Percent	Percent	Percent
Spending							
Activities	387,121	412,123	433,019	437,873	5.1	1.1	6.2
Other	17,152	20,228	13,610	16,753	-32.7	23.1	-17.2
Total	404,273	432,351	446,629	454,626	3.3	1.8	5.1
Revenue							
Activities	166,791	189,241	195,680	203,393	3.4	3.9	7.5
Rates	215,886	241,240	242,340	251,565	0.5	3.8	4.3
Other	21,438	17,633	28,492	17,939	61.6	-37.0	1.7
Total	404,115	448,114	466,512	472,897	4.1	1.4	5.5
Operating surplus	-158	15,763	19,883	18,271	26.1	-8.1	15.9

Source: Auckland City Council 1998/99 annual report and the 1999/00 and 2000/01 annual plans.

2.2 The above table highlights the continuing growth in spending by the Council. The gross cost of activities in 2000/01 is expected to increase by 6 percent from that budgeted for 1999/00. This growth arises because spending in 1999/00 is expected to be 5 percent higher than the level budgeted for that year and a further increase of 1 percent is budgeted for 2000/01. Gross spending on activities is forecast to increase by 13 percent over the two years to 2000/01.

2.3 The Council's long-term financial strategy indicates a substantial build-up in debt (excluding that incurred by Local Authority Trading Enterprises (LATEs) which is not disclosed) from about $100 million in June 2000 to a peak of $329 million in June 2004. High levels of capital spending and lower sales of investments seem to be the main reason for the forecast increase in debt. While the level of debt remains modest in relation to the value of assets, the forecast increase in debt heightens the need to scrutinise new projects closely and reinforces the argument for exiting from non-core activities.

2.4 Total rates revenue available to the Council in 2000/01 is budgeted to be 3.8 percent higher than the forecast outturn for 1999/00. This arises from the proposed increase in the level of rates (1.8 percent), the change in the value of rateable property and new property.

2.5 The increase in rates revenue is on top of a large increase in rates last year. Over the two years to 2000/01 total rates revenue is forecast to increase by 16.5 percent. Ratepayers have also borne large increases in user charges. Revenue from activities is expected to increase by 22 percent between 1998/99 and 2000/01. There is little evidence that there has been a commensurate increase in the value of services to citizens.

3 Proposed rate increase

3.1 The main argument advanced in the Plan for the proposed rate increase is that "it would take account of a forecast 1.8% rise in inflation for the year to December". According to the Plan, the increase "will preserve our real rates income for the 2000/2001 year". The proposition that movements in the general level of prices justifies a rate increase, which is often advanced by councils, is incorrect for three main reasons:

- Over time property values, and hence the annual value of rateable property, tend to increase in line with the rate of inflation. Thus, any change in the level of rates charged for each dollar of a property's annual value is a real increase in rates and not an inflation adjustment.

  The outcome of the Council's revaluation of property, which applies from 2000/01, demonstrates this argument. The annual value of rateable property increased by 25 percent from $3.04 billion to $3.81 billion between 31 January 1997 and 1 October 1999. Growth in the rating base was reported by the Council to be "generally steady at around 12–15%". This can be "accounted for partly by an increase in market value (accounting for approximately 5% on average) and partly from additional value created by development". The average increase in the annual value of each property was higher than the rate of inflation. The consumers price index (CPI) increased by 2 percent between the quarters ended March 1997 and December 1999. The additional value created by development broadly takes account of the provision of services to additional residents and firms.[1]

- There are technical reasons as to why a small increase in the measured level of inflation is judged to be consistent with a stable level of general prices. Price indices, for instance, tend to be biased upward because of statistical lags and the difficulty of identifying the impact on product prices of quality improvements.

  Recent governments have accepted that an increase in the CPI of up to 2 or 3 percent a year is consistent with price stability. Thus, if it were appropriate to index the level of rates to the rate of inflation, the first 2 or 3 percent increase in the CPI should be disregarded.

- The idea that rate or price increases are justified by reference to movements in general prices is a hangover from New Zealand's high inflation and highly regulated past. In the present environment, rate increases by councils should be justified by reference to the costs and benefits of their valid public good activities.

3.2 The Council seems to act as though it is acceptable to increase the level of rates on a regular basis. This contrasts with the approach taken by central government where increases in rates of taxation are now rare. A change in tax rates is equivalent to a change in the level of rates applied to each dollar of a property's rateable value. There have been only two rates of goods and services tax (GST) (10 and 12.5 percent) since its introduction in October 1986. There have been few changes in personal income tax rates during the same period and most changes have been in a downward direction. The top rate of personal tax, for example, has been set at 48, 33 and 39 percent while the bottom effective rate has remained at 15 percent since 1986. Middle tax rates have been cut. Other things being equal, predictable rates of tax, including rates, encourage investment by reducing uncertainty.

3.3 The Council noted that $3.7 million of the proposed increase in rates revenue "could be earmarked for a public transport fund and an Auckland Arena at Quay

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1 Auckland City Council (1999), 'Steady but Stable Growth in City's Rating Base', press release, 4 November, www.newsroom.co.nz.

Park". These projects do not justify an increase in rates. Many passenger transport projects, such as the Waitemata waterfront development, improvements to rail stations and their environs, and park and ride facilities are private good activities that should be paid for by users. The opportunity cost of some cycle-only lanes are likely to be high given the small number of cyclists that appear to use them. An additional $6 million was provided last year for public transport.

3.4 Public transport accounts for a tiny proportion of the transport market in Auckland and it can only solve a fraction of Auckland's serious traffic problems. A recent report by the Energy Efficiency and Conservation Authority notes that "the relative role of public transport (covering bus, rail, ferries, etc) in most of New Zealand is on the decline". This is despite the substantial subsidies provided to public transport. In contrast, private car ownership has increased rapidly. People prefer to use private transport because of its convenience and for other reasons.

3.5 The job of a public body is to meet valid public preferences. The Council's transport policies reflect an anti-motorist bias. The provision for spending on public transport in the Plan and envisaged in the strategic plan, *First City of the Pacific*, is well out of proportion with that for roading and is an inadequate response to growing congestion on Auckland City roads.

3.6 Passenger transport services are a private good activity – not a public good activity. Unlike public goods such as city parks and street lighting, public transport services such as buses, trains and taxis are provided by private operators and charged for in the normal way. There are no free-rider problems arising from the inability to exclude non-payers. In addition, the use of passenger transport services by one person detracts from their enjoyment by other people. The streetlight illuminates the footpath regardless of how many people pass by. In contrast, once a seat on the bus is taken it is not available for other commuters.

3.7 The mistaken view that the government has a significant role in funding and/or providing passenger transport operations and infrastructure is reflected in the policies and activities of the ARC, the region's territorial authorities and Infrastructure Auckland. Section 707ZZK of the Local Government Act 1974 (the Act) is unequivocal in stating that the principal function of Infrastructure Auckland is to provide grants in respect of certain regional transport and stormwater projects "where the projects or parts of projects generate benefits to the community generally in addition to any benefits that accrue to any identifiable person or groups of persons". If Infrastructure Auckland ignores this key qualification and makes grants in respect of private good activities it is arguably acting *ultra vires* and vulnerable to court action. The availability of its funds is not a reason to waste resources by engaging in activities that are beyond the proper role of the Council.

3.8 The establishment of a fund to finance future operating spending imposes the costs of services that benefit future ratepayers on present ratepayers. The Act generally requires operating expenses to be funded from revenue on a year-by-year basis. There are no compelling grounds for the proposed fund.

3.9 Before any decision to proceed with an indoor arena is made the proposal should be properly evaluated, and the costs and benefits of the proposal and other options should be identified as required by section 122C of the Act. That section states that:

(1) Without limiting the provisions of any other enactment relating to the funds and revenues of any local authority, every local authority shall manage its revenues, expenses, assets, liabilities, investments, and financial dealings generally, in accordance with the following principles: . . .

(c) The benefits and costs of different options are to be assessed in determining any long-term financial strategy, funding policy, investment policy, or borrowing management policy, and in making any decision with significant financial consequences (including a decision to take no action).

A principal issue to be addressed in such a cost and benefit study is whether there is a valid role for the Council in promoting, developing or subsidising such facilities. The Business Roundtable published a study last year which concluded that "The case for stadium and event subsidies is a weak one".[2]

3.10 The inclusion of spending on projects on a drip-feed basis without proper examination of the overall proposal is inappropriate. A similar criticism applies to the Council's share of the cost of developing rapid transport corridors in the region. The Auckland regional transport strategy and the Auckland regional passenger transport action plan do not satisfy the requirements of section 122C of the Act.

3.11 Some of the new policy proposals listed on page 10 of the Plan are poorly conceived, low priority or inappropriate for the Council. The imposition of efficient charges for waste collection and disposal would be a more effective response to waste management than education programmes. Such programmes do little to counter the perverse incentive created by waste collections that are free of charge to the user. Crime prevention is a central government responsibility.

3.12 One reason for last year's rate increase was to finance Asia-Pacific Economic Cooperation (APEC) meeting, America's Cup and millennium activities. The cost of these activities was $7 million. They were one-off events that should contribute to a $7 million reduction in rates in 2000/01.

3.13 The Plan states that the rate increase has been contained because (among other things) the Council has strictly prioritised spending, achieved significant savings and efficiencies in the way it does business, and streamlined its key business processes. There is little evidence in the Plan that these decisions amounted to much. The savings are not identified.

4 Proposals to cut spending

4.1 The Council should cut its spending and drop the proposed increase in rates. The following policies would contribute to such a strategy. The Council should:

- *Abandon the proposal to continue spending the additional $6 million committed to public transport last year.* Rates were increased by 3 percent in 1998/99 to fund extra spending on passenger transport and an additional $6 million was committed in 1999/2000. There are no sound public policy grounds for subsidising passenger transport services, even where roads are congested. The choices facing people are not simply between taking a bus, train or a private car. They relate to where people choose to live, work, shop and a host of other factors.

The present policy involving the construction of a transport interchange, the establishment of park and ride facilities, the upgrading of rail stations, the creation of bus-only lanes and rapid transit appears to be largely an ad hoc response to certain public interest groups and may reflect low quality advice. The proposed increase in spending appears to be inconsistent with the Council's submission on *Better Transport Better Roads* that correctly implied that all transport users should face efficient prices. This applies to users of public transport as well as motorists.

- *Sell all shares in Auckland International Airport Limited (AIAL).* The sale of shares in AIAL has been reviewed on a number of occasions. It was a key issue to be addressed in last year's draft plan and later in the draft strategic

[2] New Zealand Business Roundtable (1999), *Should Governments Subsidise Stadiums and Events?*, New Zealand Business Roundtable, Wellington.

plan. However, there is no discussion of the reasons for the Council's decision to retain its shareholding in the strategic plan, the explanatory note sent to submitters or in the Plan. The Council's decision should be revisited.

The provision of airport and related services is a private activity. Public agencies are no longer involved in competing businesses such as railways, shipping and long-distance bus services. Individual ratepayers may invest in AIAL if they wish but people who do not want to invest in it, including those on low incomes who face few choices, should not be compelled to do so, which is the implication of continuing Council ownership.

- *Sell its interests in off-street parking facilities*. The provision of such parking is a private activity. It was reported last year that the Council's gross income per car park is about one-quarter of that earned by comparable private operators. This suggests that the Council's car park operations are not only an inappropriate activity for the Council to undertake but they are also badly run and/or represent a distorting form of competition with privately owned car parks.
- *Abolish or reduce substantially city promotions and economic development programmes that subsidise some businesses at the expense of others*. The Council has no role in advising on the health of individual businesses and the subsidisation of tourism ventures is dubious.
- *Sell surplus assets*. A thorough review should be undertaken to identify assets that are not essential to the performance of the Council's core role. Such assets should be sold.
- *The Council should contract with external parties for the supply of a wider range of services*. These might include the management and maintenance of open-access parks and reserves, the undertaking of regulatory functions such as the issue of resource consents, the inspection of food premises and dog control, and administrative activities such as billing, property maintenance and design. The proposal to establish City Design as a LATE is a helpful step. Once it is commercialised it should be sold. This would strengthen competition between City Design and private providers.
- *Apply user charges where appropriate*. Activities such as libraries, art galleries, museums, the zoo, swimming pools, dedicated sports facilities and conference and entertainment venues should be predominantly, if not entirely, funded by user charges because the benefits overwhelmingly accrue to the users.

  Any subsidies provided for these activities on externality grounds should be limited to the level supported by a valid public policy analysis, be explicit and be made available to private providers of closely substitutable services.

  The funding policy is hopelessly astray, for example, in allocating 81 percent of the benefits of libraries to non-users. This implies that every time someone borrows and reads a book, 81 percent of the benefit accrues to other people. This is implausible.

  There are no grounds for complaining about the lack of regional funding for facilities where access can be denied to non-payers and user charges can be applied. Such policies encourage the free-riding that is complained about.

5 Quality of information

5.1 There are significant deficiencies in the information provided in the Plan. They include the following:

- Some major activities are inadequately examined. Very little information is provided on the Council's infrastructural activities. The Council announced in March that a new LATE, City Design, "may be established". It was later listed as a LATE in the strategic plan. As far as we can tell there is no discussion of the proposal in the Plan. The Council has a large investment in the Edge. Basic information on the usage of facilities such as the Aotea Centre is not presented.
- In the wake of last year's financial pressures, the Council reported that it had commissioned a study to examine aspects of its budgeting processes. There is no information in the Plan on the findings of the review or on any changes that have been made in preparing the Plan.
- Almost all performance measures for 2000/01 that relate to strategic issues are to be specified later (on pages 6 and 7 of the Plan). This approach is inconsistent with the requirements of Act.
- The Council has again restructured its spending categories. There is no link between the new functional categories and those used in the Council's annual report for 1998/99 and in the 1999/00 plan. It is therefore impossible to assess trends in spending at a disaggregated level.
- There is little substantive information on the Waitemata waterfront development. The Britomart development has been a controversial topic for several years. However, discussion on it in annual plans and annual reports has been minimal. Undue secrecy led to the problems that arose. The same mistake should not be made in relation to the Waitemata waterfront development.

5.2 Finally, we commend to the Council the Forum's report *Refocusing the Role of Local Government*. The report provides a detailed discussion on the core role of local government. It examines how local government should fund its activities, and gives reasons for abolishing differential rating.

The Local Government Forum

The Local Government Forum was established in 1994 to promote greater efficiency in the local government sector and to contribute to debate on policy issues affecting the sector.

The Forum comprises business organisations that have a vital interest in the activities of local government. The following organisations are members of the Forum:

- Federated Farmers of New Zealand (Inc)
- New Zealand Business Roundtable
- New Zealand Chambers of Commerce
- New Zealand Employers Federation Inc
- New Zealand Forest Owners' Association Inc
- New Zealand Manufacturers Federation (Inc)
- Property Council of New Zealand Inc.

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE 2000 BUDGET POLICY STATEMENT

MARCH 2000

2000 BUDGET POLICY STATEMENT

Executive summary

- In its 2000 Budget Policy Statement (BPS) the government outlines plans to increase government spending significantly. This is in addition to the major increases in spending during the past six years. The planned increase of $5.9 billion in provisions for additional spending over the next three years is $3.2 billion or nearly 120 percent higher than the previous government's spending plans.

- The high-spending strategy is particularly disturbing given the ample basis for concern about the quality of much government spending and about New Zealand's large and persistent current account deficits in the balance of payments.

- A high-spending strategy is a high-tax strategy. It sets New Zealand apart internationally; government spending is falling as a proportion of gross domestic product (GDP) in most Organisation for Economic Cooperation and Development (OECD) economies. In conjunction with proposed new regulations, it seems likely to heighten doubts domestically and internationally as to the attractiveness of New Zealand as a place to work, locate a business, or invest.

- Other elements of the government's economic strategy add to this concern. The announcements on the accident compensation (ACC) legislation, minimum wages and the Employment Contracts Act 1991 (ECA) are inconsistent with the government's goal of reducing the rate of unemployment to 3 percent. Nor is it remotely credible that the so-called 'jobs machine' in the form of a $100 million a year business assistance programme will have any significant macroeconomic impact, and such impact as it has will almost certainly be negative.

- The government's fiscal and labour market policies are also at odds with a low inflation goal. This increases interest rate and exchange rate risks. As the Asian and Mexican economic crises show, these risks are not trivial.

- There is ample evidence in New Zealand of fundamental structural weaknesses in the economy. However, the government's fiscal and economic strategies are at odds with the weight of international opinion about the need to promote economic growth by freeing up the economy and placing greater reliance on market mechanisms and lower tax rates. We are not aware of any other OECD country that is pursuing policies that are in line with the government's overall economic programme.

- A major theme of this submission is the need for much better communication between the business community and the government about key elements of policies as they affect businesses. Failures to communicate in 'good faith' about real issues and concerns increase the risks inherent in the government's economic programme.

1 Introduction

1.1 This submission on the 8 March 2000 Budget Policy Statement (BPS) is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily chief executives of major New Zealand business firms. The purpose of the NZBR is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 This is the sixth BPS issued under the Fiscal Responsibility Act 1994. In previous submissions we have expressed increasing concern about the rising trend in government spending. We believe that much current spending is ill-directed and serves to undermine, rather than support, economic growth and social cohesion.

1.3 Although other factors are always operating to complicate the interpretation, in our view it is no surprise that economic outcomes in New Zealand in the period since the mid-1990s have been disappointing. We share the concerns about many economic and social indicators. These include relatively poor gains in living standards, continuing high unemployment, emigration of young skilled workers, an abysmal level of literacy in much of the workforce, the domination of the knowledge community in New Zealand by public sector academics and scientists, high external debt and a deteriorating sovereign credit rating.

1.4 In our view the persistence of these problems indicates fundamental structural weaknesses in the economy. Throwing taxpayers' money at such problems does not work. Japan has spent the last decade increasing government spending rather than addressing fundamental structural problems. It is now seriously in debt as a result and its economic performance has been abysmal. The government's economic strategy should be based on a diagnosis of the sources of our structural difficulties that has expert support and is consistent with sound international thinking and experience.

1.5 In section 2 below we comment on the government's fiscal and economic strategy as revealed in the BPS and in the government's various policy initiatives to date. Section 3 identifies a number of risks that are evident in the government's strategy. Section 4 comments on problems of communications and credibility that are emerging between the government and the business community. Section 5 presents conclusions.

2 The government’s fiscal and economic strategies

2.1 A key aim of the new government's fiscal strategy is to raise the long-term spending target from 30 percent of gross domestic product (GDP) to 35 percent. The BPS plans to add further to the major increases in spending that have occurred during the past six years. The BPS states that "The previous Government's provisions in the PREFU [Pre-election Economic and Fiscal Update] totalled $2.7 billion (goods and services tax (GST) inclusive) across 1999/2000 to 2002/03. The new Government's provisions total $5.9 billion (GST inclusive) – an increase of $3.2 billion". The attached chart depicts these increases.

2.2 Government spending in New Zealand already takes a much larger proportion of national income than in many better-performing economies such as Australia, the United States, Ireland and many of our Asian trading partners. Increases in spending have to be funded largely, if not entirely, from taxation. Taxes have to be higher, sooner or later, than would otherwise be necessary. The ratio of government expenditure to GDP is the best measure of the tax burden. The change in the long-term objective of this ratio from 30 to 35 percent of GDP implies an increase of almost 17 percent in the tax burden.

2.3 Furthermore, the quality of much existing spending is poor. The government itself is implicitly acknowledging this with its expressions of concern about the weak links between outputs and outcomes and its criticisms of state-owned entities and the public service. At the same time, the government is increasing spending in areas that are difficult to justify in terms of national priorities, equity, efficiency or social cohesion. For example, the greater spending on student loans and on superannuation will benefit relatively well-off people more than poorer groups.

2.4 A high-spending strategy sets New Zealand apart from the international trend to lower tax rates and a falling ratio of government spending to GDP. Given the general policy slippage of recent years, it risks distinguishing New Zealand even more adversely in the minds of investors, businesses and potential migrants relative to the option of investing or locating in such countries as Australia, the United States and Ireland. These countries have been reducing the share of total government spending in GDP during the last several years. New Zealand has not.

2.5 Increases in government spending are hard to reconcile with the frequently expressed concerns of the minister of finance with New Zealand's large and persistent current account deficits in the balance of payments. Superannuation is relevant to the savings issue but transferring part of the operating surplus to a separate account does nothing to boost national savings or deal with the retirement income problem.

2.6 While it is pleasing to see the government's commitment in the BPS to maintaining operating surpluses across the cycle, we see significant risks to these surpluses. Section 4 discusses these risks. The government has yet to prove that it can keep within its own spending targets in the face of pressures within the coalition parties to spend more. The forecast surpluses look very vulnerable to any downturn in projected economic growth.

2.7 The volatility in the global environment is readily illustrated by the International Monetary Fund's projections of world economic growth for 1999 and 2000 in its six-monthly *World Economic Outlook*. In May 1999, it forecast that world output would grow by 0.7 percent in 1999 and 0.1 percent in 2000. The October 1999 *World Economic Outlook* issue raised these forecasts to 3.0 percent and 3.5 percent respectively. Sharp falls in world growth in the period covered by the BPS forecasts are quite conceivable.

2.8 Given New Zealand's structural problems (see section 1) it would be prudent to seize this more favourable opportunity to address them. The Organisation for Economic Cooperation and Development (OECD) recently made exactly this point:

> The improving global outlook might invite the danger that governments will become complacent and slacken their resolve to push through structural reforms that improve adaptability and strengthen the capacity of their economies to deliver high living standards. However, failure to continue with reform efforts during good times often proves costly when poorer cyclical conditions subsequently highlight problem areas.[1]

2.9 The OECD identified labour markets, particularly in many European countries, as an area in urgent need of structural reform. New Zealand's rate of unemployment, at around 7 percent in the last couple of years, is not far below the European Union (EU) average of around 9 percent and well above that of the United States and several other countries.[2] We applaud the government's commitment to a target of

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1 OECD, *Economic Outlook*, December 1999, p 26.

2 OECD, *Economic Outlook*, December 1999, p 215, estimates and projections for 1999 and 2000.

an unemployment rate of 3 percent for New Zealand. However, the economic forecasts underpinning the government's fiscal strategy project the unemployment rate to be 5.8 percent in 2004.

2.10 Moreover, the government's measures to date in respect of the accident compensation (ACC) legislation, the rise in minimum wages and the proposed changes to the regulation of the labour market all point in the opposite direction. The proposed $100 million a year 'jobs machine' in the form of Industry New Zealand is no more than a drop in the bucket of total lending to businesses in any one year, and it can only be more wasteful than private lending. While the intended subsidy element in this lending is unknown at the moment, it would be minuscule in relation to the additional costs being imposed on businesses by the increasing amount of taxation and regulation of businesses.

2.11 What strategies should New Zealand be pursuing in the face of its structural difficulties and its need to retain skilled young people and attract capital and businesses? New Zealand is not the only country struggling to find answers to these questions, and internationally the trends are clear. One governmental response has been to increase reliance on open and competitive markets as evidenced by the trend to free trade, deregulation and privatisation. Another has been to stabilise governmental accounts by reducing fiscal deficits, sometimes through fiscal contraction. A third has been to make central banks more independent and focused on the control of inflation. A fourth has been to encourage greater flexibility in labour markets as a means of reducing unemployment. The United States and the United Kingdom are two of the standout examples in the OECD region in achieving many of these policy goals.

2.12 Contrary to the widespread impression given in the media in this country, up until now New Zealand has simply been one of a crowd as a reforming country.[3] It is the current policies to increase spending and taxes and re-regulate the business sector and the labour market that will be perceived as aberrations internationally.

2.13 The high-spending approach may be well-intentioned and motivated in part by the fear that lower taxes and fiscal contraction could be bad for living standards and for unemployment. However, there is again an enormous gap between popular opinion and much professional thinking about the relationship between government spending and economic activity.

2.14 We have documented some of this literature in submissions on previous BPSs. Briefly, many countries have demonstrated that stronger economic growth has occurred during fiscal consolidations.[4] Furthermore, contrary to folklore, it is now a commonplace view amongst economists that government monetary and fiscal policies during the New Deal more likely prolonged the Great Depression than ended it.[5] In addition there is cross-country evidence that the countries that lifted government spending markedly from the 1960s to the 1980s did not obtain discernibly better outcomes on a range of social and economic measures of well-being.[6] Finally, new measures of variations in the degree of economic freedom

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3 See, for example, David Henderson (1996), *Economic Reform: New Zealand in an International Perspective*, New Zealand Business Roundtable, Wellington, August.

4 See, for example, 'Lessons from Fiscal Consolidation Experiences' *World Economic Outlook*, May 1996, International Monetary Fund, and 'Why Fiscal Consolidation is Expansionary', by Tony Makin, *Agenda*, Vol 5, No 4, 1998, pp 419–426.

5 See, for example, the overview article 'A refresher on the 1930s', *The Economist*, 19 September, 1998, p 94.

6 Tanzi, Vito and Schuknecht, Ludger, 'The Growth of Government and Reform of the State in Industrial Countries', International Monetary Fund, Fiscal Affairs Department, 1995 IMF Working Paper, WP/95/130.

across countries are providing strong statistical support for the view that prosperity would be increased in many countries if economic freedom could be increased.[7]

2.15 Our long-standing advocacy of open, competitive markets achieved by free trade, deregulation, privatisation, limited government and lower taxes is based on such research. Far from being an aberrant ideology, the thrust of this approach has strong support internationally both in the academic community and amongst the leading international policy organisations. It is also consistent with the views of many historians as to the causes of wealth amongst successful nations.

2.16 We understand that many members in the current government do not agree with these views or accept this research. We also accept that in a democracy government policies must be determined by consensus. However, there can be no stability in any consensus if policies are unsound or understood poorly. New Zealand is at risk either way. The next section looks at some of the risks. Section 4 looks at communication problems.

3 Fiscal and economic risks

3.1 Currently, significant fiscal risks include:

- Maori claims in relation to the Treaty of Waitangi and to the income gap with the non-Maori population;
- student loans (comprising both the subsidy element and the build-up in debt levels);
- defence spending;
- new spending on health, education and welfare;
- the return to a state monopoly ACC in conjunction with an intention to enhance benefits and apply lower premiums;
- a return to income-related rents in state housing and the planned increase in state rental units;
- the value of the SOEs if they lose their commercial focus;
- any move to crystallise government superannuation obligations into the Crown's accounts; and
- any marked wage increases in the public sector following the repeal of the ECA.

3.2 The political attacks on senior public servants and on high pay packets are a separate concern. The key issues should be performance and what is needed to attract highly talented people to important public sector roles. Potential candidates might be put off if they perceive that government is not committed to a politically neutral public service that is dedicated to the provision of sound public policy advice to the government of the day. If the government is uninterested in listening to advice that challenges its views on major policy issues it is likely that the State Services Commission will find it increasingly difficult to attract high quality candidates for senior positions.

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7 For a survey article and references see 'Economic Freedom, Prosperity, and Equality: A Survey' by Steve Hanke and Stephen Walters, in the *Cato Journal*, Vol 17, No 2, 1997, pp 117–146. For some critical comments on the measures see, for example, David Henderson (1999), *The Changing Fortunes of Economic Liberalism, Yesterday, Today and Tomorrow*, Institute of Economic Affairs and New Zealand Business Roundtable, Wellington, February.

3.3 Fiscal risks could exacerbate instability in financial markets if they become a point of focus during any interest rate or exchange rate crisis. The risks associated with international disturbances were noted in paragraph 2.7. Other economic risks include:

- the threat to New Zealand's credit rating for sovereign debt posed by increased spending;[8] and
- the growing tension between fiscal and labour market policies and monetary policy.

4 Issues of credibility and communication

4.1 In implementing its pre-election commitments the government has been giving the business and financial community the impression that it is not receptive to contrary advice, even from public servants. Nor does it appear to be prepared to engage in open-minded consultation with the business community about major tax and employment-related issues.

4.2 Initiatives such as the ACC measures and the proposed repeal of the ECA are being pushed through on the basis of the loosest conceivable assertions about the efficiency of a state monopoly and market power. Documents are not being put into the public domain that establish the nature of the problem, determine a robust national interest policy objective, identify and analyse the feasible range of alternative solutions to the perceived problem, or establish that the benefits of the proposed solution exceed the costs.

4.3 All too often the community at large is being given minimal time to respond. The BPS process itself illustrates that point. Arguably it represents a radical change in economic strategy to that which investors have come to accept as the norm internationally. The Fiscal Responsibility Act 1994 envisages that the BPS should lead to an opportunity for careful scrutiny of the government's budgetary proposals and to a submission process that would be treated seriously by the government in drawing up the budget. The budget, after all, is the most significant economic statement by the government in a normal year. Instead, this year's BPS is light on substantive content, contrary to the government's earlier indications that it would include specific policy detail. Also, the minimal amount of time available for scrutiny is likely to constrain the numbers and depth of submissions and limit the effectiveness of the process prescribed by the Fiscal Responsibility Act 1994.

4.4 In addition, members of the government have been putting out messages that cumulatively raise major doubts about the credibility and consistency of the government's economic programme. Besides the conflicts between fiscal and monetary policies and the balance of payments, and between labour market measures and the government's target for unemployment:

- it seems inconsistent to raise the tax payable by skilled young professionals and in the same breath call on them to return to New Zealand;
- the government's preference for a monopoly provider of accident insurance and privileges for unions, and its tolerance to date of producer board monopolies, seem inconsistent with its threats to regulate firms in network industries because of alleged monopoly problems;
- the moves to re-nationalise ACC and halt further privatisations impose enormous costs for no obvious national benefit. We are unaware of any

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8 *The Dominion*, 11 December, 1998.

other government currently in office in the OECD that has called a halt to privatisation or that has re-nationalised a major industry;

- in similar vein, it seems to be penny-wise but pound foolish to berate state agencies for mistakes, the employment of consultants and minor extravagances – blameworthy as they may be – while committing the country to major costs in respect of the tax, ACC and labour market changes;
- assertions to the effect that all or most businesses, no matter how large or small, exercise systematically unfair bargaining power over employees are seen by the business community as simply absurd;
- propositions by senior government ministers that free trade favours businesses not consumers, that any job losses from increases in the minimum wage are 'theoretical', or that students will not borrow more if loans are made interest free, point to a lack of basic economic understanding and a failure to appreciate the importance of incentives;
- it seems inconsistent for the government to impose a good faith bargaining requirement on employers when it does not seem to be prepared to consult in good faith with the business community about major reforms affecting business costs and risks;
- it seems inconsistent for the government to seek to limit redundancy payments at senior levels in the public sector while leaving the private sector exposed to the excesses of the Employment Court in respect of dismissals;
- increasing spending on students from better-off families and on better-off superannuitants is a form of redistribution from poorer to richer groups and seems to be inconsistent with a desire to alleviate poverty. Funds spent on the wealthy are funds not spent on the poor. The policies appear to be driven by vote-gathering motives, not by any principles of social equity;
- it defies logic to believe that more regulation of the sharemarket would lift share prices when the main explanations of poor sharemarket performance in recent years have been a deterioration in general economic performance and poor value creation by some of the major listed companies. If investors had viewed existing regulation as offering inadequate investor protection, the market return would arguably have been higher, not lower, to compensate for risk. As with the ACC reforms, the government seems intent on imposing a one-size-fits-all takeover regime on companies rather than maintaining a regime of shareholder choice. This approach runs counter to the strong consensus of opinion among financial economists and to international perceptions: the OECD has stated that "Overall, New Zealand's securities regulation seems to be well regarded internationally";[9] and
- to the business community it is near-incomprehensible that anyone could believe that the government's moves to get involved again in lending to industry will not eventually add to New Zealand's long list of state failures in business ventures. Politicians and bureaucrats have neither the skills nor the incentives to make sound business judgments. The most talented business entrepreneurs will not want to get involved in administering government schemes. Industry policies inevitably mean profitable firms are taxed to subsidise uncompetitive firms, and they divert firms away from customer-oriented commercial endeavours into rent-seeking activities.

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9 *OECD Economic Surveys, 1997–1998, New Zealand*, p 132.

4.5 The proposals in the BPS concerning a fund for 'pre-paying' superannuation warrant particular comment. The proposed fund cannot make any difference to the funding problem. All it does is re-label existing surpluses. Unless tax rates are increased in future or spending on benefits is reduced, the government's financial position is unchanged. The position could be worse if the government fund is invested in politically driven ways and produces poor returns, as has often been the case with such funds. The establishment of a fund could also increase government domination of the economy. The recent decision to increase the level of superannuation benefits merely makes the problem of future retirement income more difficult to manage.

4.6 Future superannuation obligations can only be made more affordable if New Zealand becomes more prosperous. This requires greater wealth creation and a willingness to save in order to build up future productive assets. Behaviour must be changed for this to occur. Re-labelling surpluses does nothing to change behaviour in the desired direction. Indeed, it could have a perverse effect if it led some people to save less in the belief that the government was saving more on their behalf. Moreover, the increase in the personal tax rate to 39 percent could also reduce savings by causing more people to emigrate, reduce their work effort, or give greater attention to tax-avoiding arrangements than they were doing under a 33 percent rate. There have been suggestions by the government that concessional tax treatment may be given for income diverted into superannuation funds. But how can a move from a 33 percent tax rate to a 39 percent rate and then back to a 33 percent rate increase savings?

4.7 The superannuation issue is another illustration of the need for far-reaching proposals to be properly analysed and debated. One of the feasible alternatives is to move New Zealand Superannuation gradually in the direction of a targeted safety net along the lines of other benefits, and to apply it at a higher age. At the same time taxes need to be lowered, not raised, to allow people more scope to save for their own retirement.

5 Conclusion

5.1 Potential communication problems between the government and the business community are not healthy for either side. If New Zealand is to have a prosperous future, businesses must be comfortable about investing in New Zealand and in creating jobs here. In the absence of better dialogue about the government's analysis of the economic problems facing the country and of its solutions to them, there is a strong likelihood that relationships between the government and the business community will become more strained.

5.2 The minister of finance has stated that he is aware of the risk that unresolved business concerns could "end up spooking customers, workers, other employers and investors".[10] However, his statement did not convey any response to valid concerns. Instead it reported that the minister defended regulation on the grounds that the government does not believe in a 'Wild West' business environment. We are not aware of anyone who has advocated a 'Wild West' business environment in either the securities or the labour markets. Nor are we aware of any credible case that New Zealand has such an environment in either market. If the minister believes otherwise then the proper thing to do is to put a discussion document to the public making the case that New Zealand really does face this problem and considering alternative solutions in a rigorous manner.

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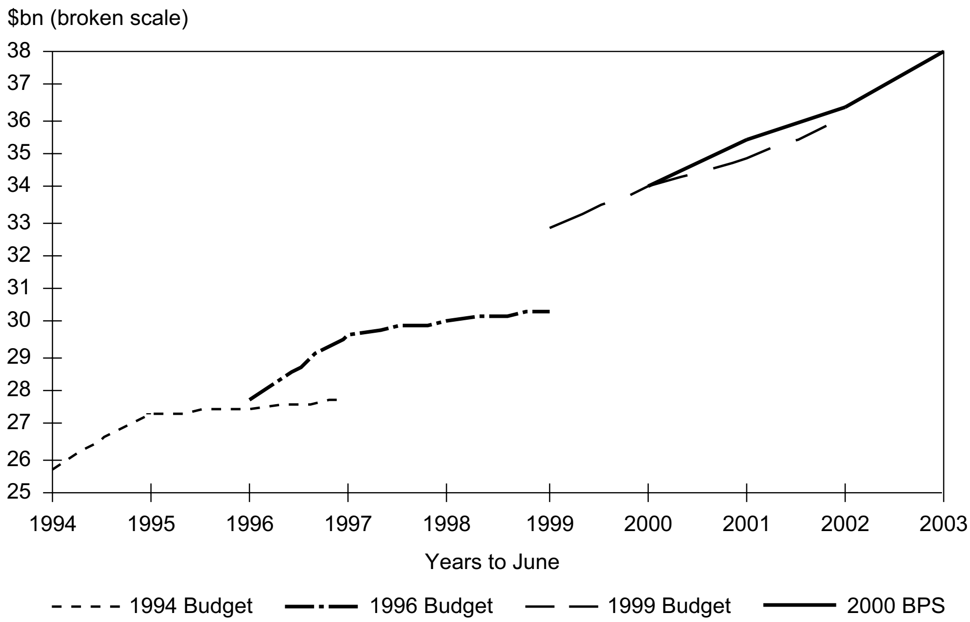
10 *The Dominion*, 'Government pro-business – Cullen', 17 March, 2000, p 13.

5.3 The questioning of the logic of certain policy proposals is not a matter of "relitigating" the election result, as has been suggested. The scope and depth of some of the policy changes being promoted by the government go well beyond what was foreshadowed prior to the election, at least to business audiences. For example, in the BPS context, Dr Cullen as Labour finance spokesman stated that it was Labour's intention "to maintain spending very largely within the limits defined by the fiscal update".[11] It is difficult to reconcile the nearly 120 percent increase in provisions for additional spending over the next three years with this statement. Moreover, surveys indicate no majority support for changes such as the ACC legislation. Governments in office have far more information than the parties in opposition and have a duty to listen to advice and reconsider unwise plans. Claiming an election mandate says nothing about the merits of policies, as New Zealand's experience in the Muldoon years demonstrates.

5.4 In our view it is absolutely essential for New Zealand's future prosperity that the government shows a greater willingness to respond to the specific concerns about its policies that are being raised by the business community. New Zealand is a small country and investors do not have to pay it much attention. If influential domestic and foreign investors lose interest in New Zealand and stop pursuing business opportunities here, it could be difficult to regain their attention.

5.5 In the BPS context, we submit that the government should fundamentally review its spending plans. High spending and taxation burdens discourage economic growth and lead to poorer social outcomes. There is ample opportunity between now and the budget to plan for lower expenditure levels, at least to within the limits of the previous government's fiscal update. The long-term goal for operating expenses should be reduced to below 30 percent of GDP. The proposed superannuation fund does nothing to resolve the superannuation problem or finance future benefits in a sensible way, and would pose new fiscal risks. A better strategy would be to continue to reduce Crown debt, while at the same time modifying the parameters of future New Zealand superannuation benefits through a consensual process and by working towards lower tax rates to facilitate private saving.

NON-FINANCE OPERATING EXPENDITURE CREEP



[11] *Otago Daily Times*, 29 October, 1999.

INDUSTRY POLICY AND REGULATION

OTAKI ROTARY CLUB

THE QUAGMIRE OF REGULATION

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

OTAKI
12 OCTOBER 2000

THE QUAGMIRE OF REGULATION

In its election manifesto last year, the Labour Party said a number of things about government regulations and the costs of complying with them.

It said "Labour's policy will be to regulate only when necessary and to ensure that regulation is fair and effective". On compliance it said "Labour will take firm action on compliance costs". Labour said it would establish an Office of Small Business "to help small firms through the regulatory maze".

What has happened since the election? It is hard to find anything that conforms with these commitments by a government that has made much of discharging its election mandate.

To the contrary, the coalition has unleashed a veritable avalanche of new regulations on the business sector. Big ticket items include the freeze on tariffs, the removal of competition in accident compensation and the re-regulation of the labour market. But there are a host of other measures: energy efficiency legislation, the application of whistleblower legislation to the private sector, gas information disclosure regulations and new regulations in the building code.

And this is just a start. The government has plans to regulate company takeovers, make the Commerce Act 1986 more restrictive, extend regulation of the electricity and telecommunications industries, introduce a minimum code of employment and new occupational health and safety regulation, and regulate to control greenhouse gas emissions under the Kyoto Protocol.

The impact of many of these individual measures will be large. The moves to make takeovers more difficult will protect incompetent boards and managements and destroy shareholder value: one estimate put the benefits of takeovers to American shareholders in the 1980s at around US$400 billion, or 51 percent of total company dividends. The law firm Bell Gully has said that the changes to the Commerce Act 1986 will "make it more difficult for some mergers and acquisitions to proceed and increase compliance costs when they do". The costs of Kyoto Protocol measures could swamp the current effects of higher oil prices.

This list is not exhaustive – it excludes greatly increased interventions in health and education, for example. Not since the Muldoon administration has a New Zealand government implemented such an interventionist agenda. The New Zealand Business Roundtable (NZBR) and many other business organisations have opposed practically all these initiatives, but the government has not been listening.

The Ministry of Economic Development has reported that compliance costs are still rising.

Recently the *Dominion* highlighted the case of a small service sector company employing 30 staff with an annual turnover of $3 million. Its compliance costs accounted for half the managing director's time, more than half of another senior employee's time, $25,000 in tax accountants' services and a similar amount in legal and other advice. The total was conservatively estimated at $150,000 a year, more than the company's latest net profit.

A new set of increases in compliance costs stems from the government's ill-conceived increase in the top tax rate that has widened the income tax scale. The new fringe benefit tax regime replaces a single rate of fringe benefit tax (FBT) with a six-rate structure involving options of paying FBT at 17.65 percent, 26.58 percent, 49 percent, 49.25 percent, 63.93 percent and 64 percent. The FBT procedures require employers to work out the cash income of the employee, deduct the notional tax liability, add the value of attributed fringe benefits, calculate a notional fringe benefit tax liability on this total, and then subtract the notional cash tax liability to work out the actual fringe benefit tax liability. This copybook exercise in tax simplification should not mean much more than a few extra weeks' paper-work a year for firms like the one in the *Dominion* article.

Other large increases in compliance costs will result from the Employment Relations Act 2000 (ERA), which replaces relatively simple employment law with a statute of nearly 200 pages containing many complex and vague provisions, and the code of good faith bargaining. The Employers and Manufacturers Association (Northern) has estimated that its 4500 members will pay over $26 million annually to comply with the ERA. But bad labour market regulation has much more profound effects. It is a major reason for Europe's high unemployment rates. The relatively unregulated and non-unionised US economy is demonstrating a far superior employment and productivity performance. The flexibility provided by the Employment Contracts Act 1991 improved the operation of many New Zealand businesses. Employment lawyers are advising that the ERA will make New Zealand less attractive than Australia in terms of employment costs and flexibility – New Zealand will lose its competitive edge. This is a huge setback.

A further effect of much new regulation relates to the certainty of property rights and the rule of law. The government has broken commercial contracts and interfered with the foreign investment approval process. Those who would invest in land and maritime resources are increasingly being denied the ability to do so as of right. A barrage of environmental legislation is undermining private property rights without compensation, on the alleged grounds of the wider public interest. This can only be a massive deterrent to investment and economic growth.

It is entirely unsurprising that in the space of a few months we have seen major falls in business confidence, a loss of investment interest in New Zealand, a sharp fall in the value of the New Zealand dollar, an exodus of talented people and a worsening of the growth outlook.

However, the government seems oblivious of the damaging effects of its policies. It seems puzzled that its so-called 'charm offensive' with business has not worked and is holding a forum later this month in Auckland to try again. But unless it is willing to recognise that it is on the wrong track and is prepared to change direction, this attempt to build bridges will be no more successful than the last one.

These blows to the economy come on top of the retreat from the efforts of the Lange-Douglas and Bolger-Richardson governments to free up the economy and reduce regulatory burdens. During the 1990s businesses faced extra costs from the Resource Management Act 1991 (RMA), the Historic Places Act 1993, the Human Rights Act 1993, the Privacy Act 1993, the Hazardous Substances and New Organisms Act 1996, disclosure regulations on executive salaries, investment products and telecommunications services, and the rulings of the Employment Court, among other new developments.

National Party members tried to tell business that they were anti-regulation, and that one benefit of the Mixed Member Proportional (MMP) electoral system was that it would slow down law making. Yet, in the last three years (1997–99) 376 public acts were passed by parliament and 1276 statutory regulations were also adopted. More regulations were passed in 1998 – some 476 – than in any previous year. It is common for three volumes of new statutes to be produced a year. The 1957 reprint of all New Zealand statutes in force comprised just 16 volumes.

Since the early 1990s, attempts to turn back this regulatory tide have been ineffective. Repeated tax simplification exercises have borne little fruit. The business compliance cost reduction programme initiated by Bill Birch and Wyatt Creech in 1994 has long since been forgotten. So too has the 1998 parliamentary inquiry into compliance costs for business.

The attempt that year to impose new disciplines by way of regulatory impact statements for new regulations has been a failure. The Ministry of Commerce (now the Ministry of Economic Development) which sponsored the initiative has set a poor example with its own statements. Responsibility for producing rigorous statements should rest with the chief executives of government departments but there is no evidence that the state services commissioner is holding them accountable for poor performance. As Rob Hosking noted in an article 'Red tape campaign fizzles out' in the *National Business Review* of 8 September, 2000, the regulatory impact statement on the Employment Relations Bill was a joke. As he put it, "the statement reads more like Labour election policy than a public service document". It simply asserts that the Employment Contracts Act 1991 was based on a contractual model and that this was wrong. There is no evidence that the analytical framework underpinning these statements has been used "throughout the policy development process" as cabinet intended, rather than as an afterthought that is no more than a rationalisation of the preferred option.

The costs of bad regulation can be very high. The total cost of complying with federal regulations in the United States has been estimated at around 9 percent of US gross domestic product (GDP), or 40 percent of the entire federal budget. An expert committee reported in 1998 that the annual cost of complying with New Zealand's tax laws a decade ago was $1.8 billion, and the cost has undoubtedly risen since then. The compliance costs of telecommunications disclosure requirements – a relatively minor regulation – run into millions of dollars. But compliance costs, which business people usually focus on, are only the tip of the iceberg. The economic costs of bad regulation arising from resource misallocation and a lack of competition are far greater, as are the economic costs of taxation relative to the compliance costs. The regulatory edifice associated with fortress New Zealand policies was a huge drag on economic performance and living standards. The gains from deregulation of markets like the labour and telecommunications markets were enormous. These are now being thrown away.

What can the business sector do about this regulatory onslaught? The short answer is resist it, comply or flee.

Resistance is expensive. It cost the NZBR over $100,000 to commission research opposing Doug Graham's foolish takeover regulation proposals, which have now been adopted. The costs to the private sector of making over 1500 submissions opposing the Employment Relations Bill, a piece of legislation that is so ill-conceived and partisan that it cannot possibly survive the next change of government, were huge. Small firms do not have the resources, especially time, to lobby governments on their proposals. The NZBR is undertaking a study of obstacles to business development that bear on small and large firms alike. The business community must keep defending the fundamentals of an enterprise system, and should not be afraid to criticise foolish actions. But when a government will not listen to business, such efforts – at least in the short term – are largely a waste of time.

So business must then comply with laws that are enacted. Most businesses in New Zealand are law abiding and try to do so. However, the task is well-nigh impossible when a medium-sized firm is typically affected by at least 40 different statutes. The Television 3 *Target* programme found recently (in its hidden camera test) that most suppliers of firewood did not know that it is now unlawful to sell wood by the cord, a measure that was once used widely in the industry. Recently a council changed its district plan allowing housing to be built near a factory and the width of its access road to be reduced. The factory now has difficulties getting its supplies in and its products out. The council says the firm should have objected to the plan when it was subject to consultation. The firm had no idea that the road was to be altered.

Large firms go to elaborate lengths to set up compliance procedures because the reputational risks to directors and executives of non-compliance are great. Smaller firms do their best but have to fly blind much of the time. Governments cynically recognise these realities. I recall a meeting with a minister in a previous administration to protest over a new, costly regulatory proposal. His response was that corporates would pay to cope with it and small firms would ignore it. Those present were shocked by this cavalier attitude to the rule of law on the part of a senior minister of the Crown.

After resisting and complying with regulations, the last option open to business is to flee. Democratically elected governments have the right to implement foolish regulations but citizens have the right and sometimes a fiduciary duty to escape them lawfully. Directors of public companies in which ordinary New Zealanders have invested funds have a responsibility to seek higher returns abroad if profitability and growth prospects in New Zealand are poor. So too do fund managers. Talented New Zealanders are leaving the country for better opportunities and lower taxes. Regrettably, government policies are causing a flight of both people and capital.

What would need to change if New Zealand wanted to get serious about turning back the regulatory tide? The answer is a great deal. There needs to be much more respect in government, the public service and the judiciary for the sanctity of legitimately obtained property rights and freedom of contract. The public needs to understand that regulation is often the problem not the solution. There needs to be much greater awareness of the importance of individual liberty. There needs to be more accountability for bad regulations, and better analysis. Ideally, we need a zero-based analysis by competent experts of all the major legislation that affects businesses. Legislation that fails the regulatory impact statement tests should be discarded or modified until what is left does satisfy them. How big a job would this be? Not insurmountable, given a government that was serious about the problem.

What about priorities? Tax is the largest compliance cost. A flatter tax scale has major virtues, but was ruled out by the minister of finance when announcing the tax review. So do lower taxes in general – which were also ruled out by Dr Cullen. The RMA with its mumbo jumbo about sustainability and its reversal of the burden of proof is imposing large costs on development. The right that dates back to Magna Carta and beyond to compensation for regulatory takings is being effectively denied under the RMA and threatened in the government's *Biowhat*? proposals on biodiversity. Business and citizens need to fight anew for their freedoms.

The government is showing no signs of delivering on its election commitment to reduce regulatory burdens. It is not listening to business or to those opposed to privilege. It is listening to those wanting to obtain privileges through regulation and spending – trade unions wanting monopoly powers restored, producer boards wanting to retain their single seller status, environmentalists wanting controls on private land without paying for them, Maori groups wanting departures from the concept of one law for all, cultural industries wanting local content regulations and so forth. There is always a good political reason behind any costly regulation, but it often has little to do with the interests of the wider community.

Professor Antonio Martino, a former Italian minister of foreign affairs, pointed out in his 1998 Sir Ronald Trotter lecture *The Modern Mask of Socialism* that "Regulation is for today's socialists what public ownership of the means of production and central planning were for them half a century ago". While ideological socialism is dead, neosocialism has been reinvented in the form of regulation. Martino drew attention to the moral dimensions of this trend, in particular the insidious consequences of:

> . . . the enormous variety of 'small' restrictions to our personal freedoms that are continuously being introduced in the name of safety, health and other lofty ideals. Each of them, taken by itself, seems trivial. Taken together, they amount to a wholesale attack on our independence . . . destroying the very concept of personal responsibility in the process.

The debate about intervention is not about whether governments have a role in the economy. Of course they do – markets could not operate without a sound framework of laws upheld by governments. But we need to be sure that the benefits of government interventions exceed the costs, because experience tells us that government failure is a far more pervasive problem than market failure.

Many New Zealand regulations are not meeting that test. Restrictions on economic freedom impair growth and economic opportunity, as many studies have shown. Forthcoming surveys will almost certainly show New Zealand falling down the international rankings of economic freedom, signifying that its growth prospects are deteriorating. With the government's moves to more 'hands on' policies, contrary to ongoing trends around the world, New Zealand is embarked on a very risky course. In this year's budget the Treasury forecast that on present policies New Zealand's average long-term growth rate (beyond 2004/05) would be just 1.5 percent a year – a lamentable outlook relative to the performance of successful countries and our own potential. It is extraordinary that the media have not been highlighting the gap between this outlook and the government's own goals.

In recent years there have been attempts to curb the growth of regulation in New Zealand, but with minimal results. Far too much legislation is still being passed. The idea of a Regulatory Responsibility Act as a discipline on regulatory policy should be revived. The only basic solution to the problem of regulatory burdens and their associated compliance costs is the same as the solution to the problem of burdensome taxes – much smaller government. Nothing else will have much effect.

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE INSIDER TRADING DISCUSSION DOCUMENT

OCTOBER 1999

SUBMISSION ON THE INSIDER TRADING DISCUSSION DOCUMENT

1 Introduction

1.1 This submission on the Ministry of Economic Development's September 2000 discussion document on Insider Trading is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily chief executives of major New Zealand business firms. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 We have long regarded the existing legislation embodied in the Securities Amendment Act 1988 to be seriously deficient. No sound case was ever made for New Zealand's current insider trading law. Insider trading was not a general common law offence, in the United States at least.[1] The New Zealand law, in common with the law in overseas jurisdictions that it followed, wrongly assumes that the victim is the party trading with the insider. In fact those trading unknowingly with an insider will commonly benefit from the insider's activity. This is because they could have been expected to have to pay a higher price if buying, or receive a lower price if selling, were it not for the insider's trading.[2] Where unauthorised use is made of information, redress should be an issue between the rightful owner of that information and whoever misused it. Another way to illustrate this fundamental deficiency is to note that a law focused on making the act of trading an offence fails to capture those who use inside information in order not to trade when they would otherwise have done so. No legislation can be expected to be satisfactory unless its fundamental deficiencies have been addressed.

1.3 In our view, if the existing legislation is causing significant concerns, resources should be devoted to a 'back-to-basics' review of its entire rationale rather than to making amendments that preserve its unsatisfactory structure. The minister of commerce is reported to have said that a zero-based review would be "an excuse to do nothing for at least two years". This is hard to follow. First, a zero-based review is doing something. Second, all relevant alternatives should be considered if the objective is efficient regulation. Third, the statement implies that there is a problem so urgent that something must be done immediately, even in the absence of a thorough analysis.

1.4 Section 2 of this submission considers what the government's objective might be if it is not efficient regulation. Section 3 reviews the evidence that there is a problem that is so urgent that something must be done even in the absence of a thorough-going review. Section 4 comments on specific items, including the discussion document's definition of insider trading and the issue of forced disclosure. Section 5 comments on the issue of compatibility with Australia. Section 6 presents some conclusions.

2 Policy objective

2.1 The ministry's covering letter of 5 September to the Insider Trading document states that one of the government's key objectives is to promote confidence in the sharemarket. Given this objective, we would presume that the government would rely heavily on the opinions of the New Zealand Stock Exchange and its members

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1 See pages 860 and 883 in Dennis Carlton and Daniel Fischel, 'The Regulation of Insider Trading', *Stanford Law Review*, May 1983, pp 857–895.

2 The exception occurs where the trader would not otherwise have traded.

on the source of any problems that relate to confidence. They must surely be more committed to this goal than any other group in the community. They are also surely the most knowledgeable about any problems of confidence.

2.2 Senior ministers and regulators have a responsibility to preserve and enhance the reputation of New Zealand's markets rather than to undermine them. Unfortunately, those in positions of authority pushed through the current insider trading regulations in 1988 under the catch-cry that New Zealand's markets were the last frontier of the Wild West, whereas in reality our laws were solidly based on longstanding English law. The prime minister's recent use of the same language to justify the adoption of the Takeovers Code was unfortunate in this respect.

2.3 For these reasons we think it is particularly important that proposals to modify securities laws be justified by a sound, rational public policy analysis rather than by unproven assertions about the need for yet more regulation.

3 Problem definition

3.1 The ministry's covering letter states that there is a perception in the market that the current regime is inadequate. Surprisingly, in the light of this claim, the discussion document makes no such assertion. Nor does the document provide any evidence that a problem of perceived undetected insider trading exists to a greater degree than occurs in other markets, let alone that any such difference is soundly based and material. Instead the discussion document appears to identify the problem to be that no person has yet been found liable for insider trading under the Securities Amendment Act 1988. The minister is reported to have expressed the same concern and concluded that "either New Zealanders are all lily-white and honest, or there is something wrong with the regime".[3]

3.2 We have asked the Ministry of Economic Development if there is any information that shows there have been more actions for insider trading in Australia than in New Zealand, on a scale-adjusted basis. We understand independently that there is a view in Australia that the number of prosecutions has been unduly low, perhaps because of the burden of proof. Possibly this legislation has generally proven to be difficult to make work. Carlton and Fischel commented in 1983 that insider trading regulations in many countries had either not been enforced or did not exist.[4]

3.3 We have also asked the Ministry of Economic Development for the information on which it based its assertion that there is a market perception problem. As already noted in section 1, market perception problems are bound to occur when leading officials and politicians promote new regulation by talking disparagingly about the integrity of the existing market, as occurred in 1988.

3.4 Perceptions that financial regulation is inadequate are surely insatiable. Black letter law as to what constitutes information given in confidence, what is price sensitive information, and who is an insider, is inescapably troublesome. There will always be those people who will argue that the trade-offs have been drawn too loosely. Others will have an irreducible perception that regulation is inadequate unless it ensures that all are equally informed. This is hopelessly utopian, but the view will probably always exist. Then perceptions that law is inadequate will always arise because of international differences in regimes. Some of those people who are accustomed to regimes that are highly intrusive and who are comfortable with them will inevitably view behaviour in countries with less intrusive regimes as evidence that those regimes are inadequate. We have seen this in relation to the

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3 *New Zealand Herald*, 28 September, 2000.

4 Carlton and Fischel, *op cit*, p 860.

debate on the takeovers code. Such demands for additional regulation surely mean that the existence of negative perceptions should never be taken as proof that further regulation will do more good than harm. There can be no substitute for scrutiny and analysis of such perceptions.

3.5 Our consultant has made some informal inquiries amongst local market professionals to uncover their perceptions about insider trading in New Zealand. The evidence that New Zealand is perceived to have an insider trading problem *relative to other countries* appears to be tenuous.[5] The evidence that any such perceptions are soundly based appears to be even weaker. We have asked the chief executive of the New Zealand Stock Exchange if the Stock Exchange perceives insider trading to be a real problem, as distinct from a perceived problem. We understand that it does not. A very experienced local broker in a major investment bank has commented that the internal rules within major international investment banks are so stringent that undetected insider trading by any staff member is virtually inconceivable. Colleagues in a major local law firm expressed concerns about imbalances in information, briefings of analysts, perceptions that stories do exist of individuals who 'push the limits', but none stated that they saw it as a major problem or that New Zealand stood out in this respect. A related suggestion was that company officers in a target company that was not experienced in dealing with takeover offers, and therefore less alert to the need for proper processes and sound security systems, might be more likely to succumb to the temptation to trade improperly. One major fund manager said that he was not aware of any concerns that insider trading was a particular issue with the New Zealand market. However, one local professional fund manager did say that he knew of some investors in the United States who were concerned about the possibility of unreported trading by New Zealand directors. Presumably boards would change their rules about trading by directors were these issues sufficiently important.

3.6 Another possible source of concern stems from academic research that finds that share prices typically tend to move in advance of a significant company announcement. However, we are not aware of any research that finds that New Zealand stands out in this regard. Share prices that are 'strong form efficient' should, by definition, incorporate information before it is publicly disclosed. Such impounding of information could occur because of proper or improper insider trading, loose talk, or intelligent guesses by trained or untrained outsiders. Loose talk is more likely closer to an announcement, as more people become involved. But markets can anticipate pending announcements even in the absence of loose talk or improper trading. A company's officers can be asked any day of the week about how their company is doing by friends, associates, advisers or potential advisers, suppliers, customers, analysts, journalists and others. Professional analysts and financial journalists are expected to be the first to nose out important new information. When a major announcement is pending, company officers and directors face an unenviable dilemma: they can lie, evade, or, if the request is not face to face, go to ground. The first is not tenable for any reputable company. The second and third signal to the actual or would-be questioner the possibility that something could be going on. Even a failure to return a journalist's calls about a rumour will be information. There may be no neutral position.

3.7 None of this is to argue that New Zealanders are any more or less 'lily-white' than anyone else. Inevitably, some will attempt from time to time to put inside information to improper use. Many more will just talk indiscreetly. This is human nature. Any view that more regulation can *eliminate* the improper use of

5 A couple of professionals commented that the Force Corporation case had created negative perceptions, but they did not claim that it made New Zealand stand out in this respect. They did not appear to have a clear view on whether the problems arose from weaknesses in the legislation or in its enforcement.

information is simply utopian. By the same token, as already noted, no amount of regulation can hope to dispel perceptions that insider trading is a problem. No one can prove that what is undetected does not exist.

3.8 The only sound way to proceed would be to establish that there are material perception problems *and* that they have a foundation in reality. Those people putting forward the current proposals have failed to establish either.

3.9 Both the Insider Trading discussion document and the minister's reported comments make unequivocal and unsubstantiated assertions about the materiality of possible 'gaps', including the costs of private legal action. As it happens, the executive director of the New Zealand Business Roundtable is currently taking legal action on an insider trading case in a private capacity. Officials have not consulted him about the costs of this well-publicised action. If they had done so he would have been able to tell them that they are not so high as to present any formidable obstacle, even to an ordinary investor. What then is their authority for asserting in paragraph 1.5 of the discussion document that such costs "all act as significant barriers for individuals in taking an action"?.

4 Analysis of the alternatives

4.1 The only alternatives considered are those based on closing perceived gaps, and on taking the existing framework as given. The minister's reported comments acknowledge implicitly that the regime might itself be fundamentally at fault, but they immediately rule out the option of investigating that possibility.

4.2 The discussion document adopts an extraordinary definition of insider trading, namely trading in securities with the benefit of information that is not publicly available (paragraphs 1.9 and 4.1). Such a definition would potentially appear to preclude all trading because the public does not know the reservation prices of each buyer and seller. Nor is the product of the research conducted by professional investors for their own purposes in the public domain. This definition is so bizarre as to undermine confidence in the discussion document as a whole, thereby creating doubts about the value of attempting a full response and the soundness of any decisions that finally emerge.

4.3 The document provides no framework whatsoever for considering the desirability of preserving incentives to invest in information and the ability of shareholders and managers to contract for the allocation of property rights in company information. Specifically, it does not consider the option of letting stock exchanges and companies determine their own rules about share trading by directors and staff. Richard Epstein has provided an insightful analysis of the contemporary conflict between forced non-disclosure (eg a Privacy Act) and forced disclosure.[6] He discusses the specific case of insider trading and makes the point that no major externalities are involved.[7] Shareholders can readily vote to determine what rules should apply, company by company. They would not have needed to wait for the Securities Amendment Act 1988.

4.4 Forcing the disclosure of information has obvious benefits to those whose privacy is not at stake and who have not got a possibly significant portion of their wealth tied up in shares in a company.[8] But there are costs to this exaction, as with any other confiscation of wealth. It could become more costly to recruit directors and staff

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6 Richard Epstein, (1996), *The Concealment, Use and Disclosure of Information*, New Zealand Business Roundtable, Wellington, August.

7 *Op cit*, pp 17–18. See also the Carlton and Fischel article cited above.

8 The 'Shake-up needed' article by Brian Gaynor, *Weekend Herald*, October 7–8, 2000, considers only such benefits, ignoring entirely the costs of forced disclosure rules.

and more difficult to incentivise them. Share prices may be less efficient. For example, trading by directors may be inhibited even when false rumours are circulating that trading by directors might serve to dispel (eg by purchasing shares at a time when a company is rumoured to be in difficulty).

5 Compatibility with Australia

5.1 The document asserts at paragraph 1.13 that there are obvious advantages from coordinating New Zealand and Australian law. While it fails to consider any disadvantages, it does state that it would welcome submissions on the appropriateness of Australian law being adopted in New Zealand. We submit that there is no substitute for a thorough and rigorous analysis of the net benefits of any proposed regulations for New Zealanders. We are not aware of any expert body of opinion that holds Australian regulations in high esteem in an international context. Competition between regulatory regimes is desirable, as the example of the states within the United States illustrates. If New Zealand wants companies to locate in New Zealand rather than Australia, based on comparative advantage, it should seek to ensure that its regulations are efficient.

5.2 The economic literature on regulation has established that regulations are commonly introduced for the benefit of interest groups, often the regulated industries, rather than for the benefit of the public.[9] The adoption by New Zealand of Australian regulations implies the adopting of a set of regulations that emerge from Australian political processes. These may not give much weight to any characteristics that make the New Zealand market different from that in Australia. Indeed, some lobbyists may desire to grow the Australian market at the expense of the New Zealand market. This is not an argument about allowing market institutions to merge; it is an argument against allowing another parliament to determine what regulations New Zealand will adopt.

5.3 Globalisation is another factor to take into account. Australia is only part of a wider picture. Arguably New Zealand governments are going to have a diminishing influence over the regulatory environments that affect production in New Zealand. As New Zealanders invest globally, more New Zealand assets will be owned by foreigners. Major overseas firms are likely to apply the same professional standards to the New Zealand market that they are accustomed to applying in their home markets. Similarly, New Zealand firms should find it increasingly practicable to raise capital and to list on overseas markets. The less efficient are New Zealand's regulations, the quicker such effects will be felt.

6 Concluding comment

6.1 Perhaps reflecting a predetermined approach by the government to the issue, the discussion document fails to raise the fundamental problem with this legislation that we summarised in paragraph 1.2 above. It is hard to see that any amendments to this legislation can prove to be satisfactory while these flaws remain. We suggest that the ministry survey the experience overseas with legislation of this type to establish if there is any jurisdiction in which its troublesome nature is not in contention.

6.2 Putting this question to one side, the original legislation failed to create any clarity about what constituted information given in confidence and what constituted price sensitive information. It clearly impeded legitimate activities while not obviously impeding improper activities. The existing legislation was likely to be draconian if

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9 See for example pp 10–11 and 326 in *Economics of Regulation and Antitrust*, second edition, W Kip Viscusi, John M Vernon, Joseph E Harrington, MIT Press, 1998.

vigorously enforced, or ineffectual (and thereby relatively harmless) otherwise. The current proposals seem to risk shifting it towards the former extreme. It is difficult to contemplate anything more extreme than the definition of insider trading in paragraph 4.1 of the discussion document.

6.3 From a public policy perspective, the ministry's current analysis fails to establish that the alleged adverse market perceptions warrant the adoption of the proposed measures. It even fails to establish the source of any such perceptions – such as the failure of politicians and regulators to defend adequately markets, profits or even capitalism against ill-informed populist attacks. One might as well argue that there is a perception that profits are bad, therefore all profits should be regulated. There is no attempt to ascertain whether what is proposed will actually alter negative perceptions.

6.4 As a practical matter, we are discouraged from putting more resources into this submission because it seems that the government's mind is made up. We believe that far from increasing confidence in the sharemarket, the government will simply exacerbate perceptions that it is hostile to business and is not prepared to undertake or listen to any proper public policy analysis of its proposals.

6.5 We submit that the government should insist on a competent and rigorous analysis of the proposals in the discussion document and the existing legislation before taking any decisions.

IMPORTERS INSTITUTE CONFERENCE

'THINK SMALL' IS NO BETTER THAN 'THINK BIG'

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

AUCKLAND
14 SEPTEMBER 2000

'THINK SMALL' IS NO BETTER THAN 'THINK BIG'

This year's budget contained a section on economic development. It was all about the idea that the government can help the economy by giving money to business.

The centrepiece of the government's economic development programme is the creation of Industry New Zealand with a budget rising to around $100 million a year. Its principal architect, the deputy prime minister Jim Anderton, has told us that "the free market policies of the last century failed" and that the coalition government would be much more 'hands on'. Leaving aside the point that the last century was the century of big government, let's examine his plans:

> Together with local agencies and the private sector, the Ministry [of Economic Development] and Industry New Zealand will identify resources and opportunities for economic development.
>
> The range of partnership contributions the government can make is limited only by the imagination of those involved and the needs of the economy. There will be venture capital available. Development grants and loans for both new enterprises and to help fund business expansion will be available . . .
>
> The new approach will be flexible and dynamic. It if works well, we will do more of it. If it doesn't work, we'll stop doing it.

When I last shared a platform with Pete Hodgson, now minister of energy, on this subject about a year ago we were in agreement on one point. Mr Hodgson was willing to concede my argument that the impact of this programme on the economy would be small. We differed as to whether it would have a small positive effect or a somewhat larger effect but we agreed we were talking about a 'Think Small' programme not a 'Think Big' one.

Let me begin by explaining why the economic consequences of the government's so-called 'jobs machine' would be almost invisible even on the most favourable assumptions. I shall then go on to explain why the consequences are likely to be bad rather than good, and to be a distraction from the serious debate we need about how to improve New Zealand's economic performance.

Consider some basic arithmetic, which I will keep simple and in round terms. Suppose, to begin with, that the government's $100 million programme is new money: you might think of it as manna from heaven, or from some hypothetical Brussels of the South Pacific. What difference might it make to national income and our stock of jobs?

Well, New Zealand is roughly a $100 billion economy; national income or gross domestic product (GDP) is a bit over that figure a year. That income is produced from a stock of productive capital (I exclude residential investment) that has been estimated to be about $300 billion.[1] On this basis we use about $3 of capital to produce $1 of national income or, as an economist would say, our capital: output ratio is about 3 : 1.

If we were given an extra $100 million as manna from heaven, what could that amount of investment get us by way of extra national income? With a capital: output ratio of 3 : 1 and on the assumption that the productivity of the new capital is the same as that of the capital already in place, the answer is about $33 million a year.

That $33 million is an addition to the national income figure of $100 billion; in other words it is an increase of 0.033 percent. Any increase is worth having, but this figure needs to be

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1 Erwin Diewert and Denis Lawrence, *Measuring New Zealand's Productivity*, Treasury Working Paper 99/5, p 255.

set alongside the government's aim of improving New Zealand's economic performance. The minister of finance, Dr Cullen, has spoken of raising New Zealand's annual average growth rate to 4 percent or more. If, on the most favourable assumptions, the Industry New Zealand programme contributes 0.033 percentage points to this 4 percent target, the obvious question is where the other 3.97 percent is going to come from. Mr Anderton could double or treble the size of his 'jobs machine' and he would be nowhere near in sight of a credible growth strategy. It pales into insignificance by comparison with the contribution to growth of policy reforms like the removal of the state monopoly in workplace accident insurance that the government has foolishly reversed.

Let's now look at the same sort of arithmetic in terms of jobs. There are about 1.8 million people employed in the New Zealand workforce. Using the $300 billion figure for our capital stock, this means that each worker on average is backed by around $167,000 of capital. If the government injects an additional $100 million into the economy (still using manna from heaven), and assuming $167,000 is needed for each job, it follows that about 600 new jobs will be created each year. Since the Employment Contracts Act 1991 (ECA) came in there has been a net increase in employment in New Zealand of around 300 000 jobs, or around 37 500 a year (not all due to the ECA, of course). With the government's 'jobs machine' creating 600 jobs a year at most, it will take over 60 years for it to match the annual increase in employment that New Zealand has recently been achieving.

Clearly some of these estimates, particularly the value of the capital stock, are imprecise. It could also be argued that the assumptions used are not the most favourable. For example, it could be argued that the new investment might be more profitable than the old, or that the projects it supports might be more labour intensive or 'job rich'. Ironically, if they are more 'job rich' that will mean they will marginally depress growth in labour productivity, and the government has been complaining, albeit mistakenly, about New Zealand's low labour productivity growth in the post-ECA period when employment was growing strongly. But regardless of the estimates and the assumptions, one thing is abundantly clear: the impact of the Industry New Zealand programme will be at best small, even trivial, in the context of economic growth and employment in New Zealand.

But will this small effect at least be positive? The last investment programme of a 'hands on' government, Think Big, was also supposed to have positive results – remember those 410,000 new jobs. It turned out to be a giant lemon. Why would Think Small not also be a lemon, albeit a more stunted one?

I suggest there are four main reasons why the latest initiatives will also turn out to be a lemon.

First, the investment funds involved are not manna from heaven. They are taken from citizens who would have spent them differently, and each dollar spent by the government costs more than a dollar to raise. The disincentive effects associated with taxation, combined with the administrative costs for the government and the taxpayer, mean that it probably costs at least $1.25 to raise a marginal dollar of tax revenue in New Zealand. So in raising $100 million the government knocks some $25 million off the economy – it is behind at the start by that amount in terms of its goal of raising national income. Its investment projects have to be very profitable to make up that deficit and yield a normal return. If they were that profitable, it would be surprising if private entrepreneurs had not spotted them. Tax-financed investments are almost by definition economic losers on average. Taxes need to be treated like the scarce resource they are and not used for projects that could be financed without incurring the deadweight costs of taxation.

Secondly, even if no deadweight costs were involved, capital, skilled labour and other resources are drawn away from other firms or industries when governments fund a particular firm or industry. Resources are shuffled around the economy, away from activities that can stand on their own feet and into activities that are only viable because of government subsidies. We invest more in activities that are less competitive. The result from a national point of view is that resources are misallocated and potential national income is lost.

Thirdly, each dollar taken from someone will probably be spent less wisely. The decisions in so-called economic development programmes are made not just by entrepreneurs putting only their own money at risk but also by politicians and bureaucrats risking taxpayers' money. Even if private sector people are involved through a government board, they are not risking their own money, and most talented business people want to be running their own businesses, not sitting on government boards. The history of government investment funds picking profitable winners is notoriously poor, as the experience of the Development Finance Corporation should remind us. In the budget, Michael Cullen claimed that the government did not want to be picking winners, but that is inevitably what is involved with a government investment fund. Jim Anderton was at least honest enough to recognise this in saying "Together with local agencies and the private sector, the Ministry [of Economic Development] and Industry New Zealand will identify . . . opportunities for economic development".

Australian experience confirms these last two points. The Australian Industry Commission (now Productivity Commission) reported that government investment assistance:

> . . . at best, shuffles jobs between regions and, at worst, burdens tax and ratepayers, reduces the competitiveness of Australian industry and the income of Australians as a whole. The experiences of some States also illustrate the risks faced by governments which directly target firms to promote economic development. The Victorian Economic Development Corporation, abolished in 1993, is a well documented case which left taxpayers footing a $111 million write-off.

Fourthly, economic resources are also wasted through the unproductive activities associated with government assistance programmes. They are inevitably bureaucratic and costly to administer. They encourage business people to spend time lobbying rather than growing their businesses. Taken very far, they breed a culture of political favouritism or worse, as we saw in Asia and indeed in New Zealand in earlier years.

All this suggests that the government's economic development programme is highly unlikely to be good for the economy. It will benefit a few favoured firms, but will be harmful for economic growth and employment overall. I am unaware of any economic analysis that addresses these arguments and reaches an opposite conclusion.

It is no response to suggest that New Zealand governments need to give money to business because other governments do. Other governments do many foolish things, from running banks and airlines to subsidising farmers. When foreign governments subsidise their industries they primarily hurt their own economies but they also hurt others by polluting the international trading environment. But it makes no sense for someone to take up smoking because they are worried that their health is being affected by passive smoking. We do ourselves no favours by adding self-inflicted damage to the damage caused by others.

It is also no argument to point out, as some of our older industrialists do, that their firms would not have got started without government assistance. In some cases this may well be true; we cannot expect governments to be consistent enough to get it wrong every time. However, we have to look at overall tendencies. The argument overlooks the point I made earlier that for every firm that was assisted, some other firm or firms were disadvantaged or were never born – there is no free lunch with government interventions. We will never know exactly what pattern of industry might have emerged in a less distorted environment. Of course many of the infant industries or firms did not survive when their protection or subsidies were removed.

Nor is it relevant to note that New Zealand might miss out on the international investments of some multinational company if it does not match the incentives that other governments offer. Today technology companies are a fashionable target; in the 1970s it used to be vehicle manufacturers – remember the de Lorean fiasco in Ireland. But the same argument applies: such projects can only be helped at the expense of other unsubsidised projects. The general presumption that New Zealand benefits from foreign investment does not apply if projects are subsidised. Moreover, government incentives have a well-deserved reputation of being 'here today and gone tomorrow', and they have far less impact on location decisions than things like low tax rates and a well-educated workforce. Silicon Valley does not exist because of Washington. As one technology company chief executive recently put it, "Capitalism is what people do when they're left alone".

The same kind of arguments that I have been making apply to other proposed forms of business assistance such as export credit guarantees or research and development (R & D) subsidies. All such programmes engender a corporate welfare mentality. The government responds to the claims that it is anti-business by pointing to the number of handouts it plans to provide. This presumption that the business community will be fooled if the government takes a dollar in taxes and returns, say, 10 cents in subsidies can only irritate business further. Selective business programmes are no substitute for broad-ranging reforms to reduce tax and regulatory barriers to economic growth. This is the lesson from Ireland that had long subsidised businesses to no avail and only took off when it adopted more orthodox policies in the late 1980s. When business groups seek incentives of various kinds, they divert attention away from the fundamental reforms needed to build a sound economy.

The government has a very important role to play in the economy, but it is not one of deciding whether New Zealand should have a possum fur industry. Governments need to concentrate on their core functions – essentially to ensure the provision of genuine public goods and a safety net – and to perform them well. They have extended their activities well beyond their areas of competence. It is ironic to speak of free-market policies when the government share of the New Zealand economy is a preposterous 40 percent and when businesses have been inflicted with increased regulatory and compliance costs in recent years. The main reason why the economy is not doing better is that, unlike many other countries, New Zealand has made only sporadic attempts at serious reforms in the past 15 years and has paid an enormous price for the policy dithering since the early 1990s. Now the government is implementing policies that are outdated and out-of-step with the rest of the world, and we are seeing the inevitable results in the form of the falling currency, the outflow of talented people and the worsening growth outlook.

The business community must keep explaining the facts of economic life to the public, and keep pressing for the fundamental policy changes that will lift economic performance. Last year the New Zealand Manufacturers Federation stated that "it considers a significant cut in business tax would be more effective and cause less distortions than tax measures targeted at specific areas such as R & D that could influence business choices for tax rather than value-adding reasons". This year some people in business have forgotten that message and are heading back down the corporate welfare path, including arguing for R & D tax concessions.

They should stop and turn around. Business organisations said 'thanks, but no thanks' to Winston Peters's $100 million package of business assistance and they should respond the same way to the $100 million that the coalition government is offering. After all, Mr Anderton has said "if it doesn't work, we'll stop doing it"; business can tell him why it does not work before he starts, and why thinking bigger would be even worse. 'Think Small' may do less economic damage than 'Think Big', but it is equally ill-conceived, is no answer to New Zealand's problems, and is a distraction from the task of putting together the strategy for economic growth that New Zealand desperately needs.

GAS ASSOCIATION OF NEW ZEALAND
ENERGY SYMPOSIUM 2000

ENERGY EFFICIENCY

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

AUCKLAND
28 AUGUST 2000

ENERGY EFFICIENCY

On a 1995 visit to New Zealand, the distinguished legal scholar Richard Epstein made the following remarks:

> Whenever somebody tells you that something is special, remember that the history of government failure is littered with arguments that this, that or the other thing is special. We had labour unions in the industrial sector because it was special; we had Medicare in health because it was special; we had subsidised public housing because housing was special; we had price controls in agriculture because it was said to be special. It turns out that there is nothing special about anything. A few central principles consistently applied will tell you the appropriate scope for individual choice on the one hand and for government action on the other.

Epstein was not, of course, denying that all manner of things we use, make and do have distinguishing characteristics. His point was simply that far fewer than is commonly supposed have features that call for exceptions to be made from the general principles of public policy. Much the same goes for commercial strategy as well.

New Zealand has been ignoring this lesson recently. The government regards the labour market as special, not a place where normal contract law should apply. It regards the energy market as special, and intends to return to a form of central planning with a National Energy Efficiency and Conservation Strategy. As yet it has no plans for a national strategy for food production or internet applications, though one hesitates to raise ideas.

I am for energy efficiency. I want to see scarce energy resources used in ways that will make the largest contribution to New Zealanders' living standards. But I am equally concerned about the productivity of labour, land, the internet and all other economic resources. We want to avoid wasteful use of all of them and we want them to be used in activities where they are most valued. This means it may well be efficient, for example, to 'waste' some energy in order to waste less of something more valuable – like human lives.

On the other hand, I see no argument for either special privileges or special penalties for any of these resources. Why should a review of the tax system single out the wasteful use of non-renewable resources as the government is proposing? Surely the aim should be to minimise the waste of all resources, which is the reason for examining the tax burden.

Concerns about energy have been the subject of wild swings in popular opinion in the past 30 years. Julian Simon reported that the percentage of the American public that

said energy is "the most important problem facing the nation" jumped from 3 percent in September 1973 to 34 percent in January 1974 following the Organisation of Petroleum Exporting Countries (OPEC) oil price increases, and then quickly fell back down to 4 percent. At the time of the second oil price increase in 1979 fully 82 percent said that the energy situation in the United States was "very serious" or "fairly serious" but then public concern quickly dropped again.[1] Today most of the anxieties over energy, population and other environmental 'scares' of the 1970s have largely dissipated as research and experience has shown them to be unfounded, though some interest groups and politicians still seek to fan the fires.

Back in the 1970s and early 1980s we learned some lessons that it would be painful to have to learn over again. The whole Think Big fiasco and the notion that we needed a ministry of energy stemmed from the idea that energy was so special that governments needed to intervene comprehensively in energy markets. We preferred the absurd spectacle of carless

[1] Julian Simon, (1999), *Hoodwinking the Nation*, Transaction Publishers, New Brunswick, pp 10–11.

days to efficient prices for energy. But bringing in regulations to limit car use is no more absurd than the government's recent decision to bring in regulations to limit energy use in buildings.

There is much confusion over energy efficiency. Four sources of confusion deserve special mention.

First, energy efficiency should not be confused with whether an economy is energy intensive or not. New Zealand's overall energy use per unit of gross domestic product (GDP) – its energy intensiveness – is not out of line with that of many comparable countries – for example many in Europe. To the extent that energy use in some sectors is higher, this reflects things like New Zealand's comparative advantages in some forms of energy production and the preferences of consumers. If we did not exploit these comparative advantages or satisfy these preferences our economy would be less efficient. Some economies will always have a higher energy intensity than others: energy intensity is merely a statistical measure with no automatic connotations for economic efficiency. The draft report by Lee Schipper *et al* for the Energy Efficiency and Conservation Authority confuses the two issues when it talks about the ratio of energy use to GDP as being a "surrogate for energy efficiency".[2] The report's finding that New Zealand's energy intensity is declining, and is expected to continue to decline, is confirmed in the latest *Energy Outlook* from the Ministry of Commerce.

Secondly, people confuse economic efficiency (which is what matters for living standards) with the technical efficiency with which energy is used. There is no point trying to maximise technical efficiency if it makes people worse off. To illustrate the trade-offs, lighter vehicles may use less fuel, but they may also be less safe. Similarly, the most energy-efficient buildings may be inconvenient in use and uncomfortably hot in summer. Mandatory energy efficiency requirements are likely to fall particularly heavily on low-income households as they tend to drive up the capital costs of buildings or equipment. Should middle class voters impose their views on what constitutes value for money for the poor?

Thirdly, energy is sometimes regarded as special because some forms of it are non-renewable. But New Zealand minerals such as ironsands and rock aggregates are more or less non-renewable, yet no one proposes special taxes or 'national strategies' for them or regards their depletion with particular concern. There is no evidence, worldwide, that energy resources are becoming more scarce. Julian Simon won the celebrated 1970 bet with environmental doomsayer Paul Ehrlich that natural resources would become cheaper rather than more expensive by 1990, indicating that they would be less scarce. Under the baseline scenario of the Ministry of Commerce, the prices of electricity, gas, oil and coal to end consumers are projected to stay at current levels to 2020 in real terms. Many of the same people who worry that the world is going to run out of fossil fuels also worry about global warming. They cannot have it both ways.

Fourthly, it should not be assumed that greater energy efficiency and a better environment are one and the same thing. It is easy to identify situations where greater energy efficiency conflicts with environmental and other concerns. For example, it might be energy efficient to bulldoze a road directly through an environmentally sensitive area. Alternatively, the more fuel-efficient vehicle may be the noisiest or least safe. In the case of renewable forms of energy, wind farms can be extremely unsightly and are often controversial on environmental grounds.

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2 Lee Schipper, Fridtjof Unander, Céline Marie-Lilliu, Ian Walker, International Energy Agency, and Scott Murtishaw, Lawrence Berkeley National Laboratory, 'Indicators of Energy Use and Efficiency in New Zealand in an International Perspective: Comparisons of Trends Through 1995', EECA, August 2000.

As the resolution of the oil crises of the 1970s finally demonstrated, private markets are far more effective than government planners in promoting the efficient use of energy resources. Markets are uniquely well equipped to handle adjustments on both the supply side (new exploration, new technology, substitutes) and the demand side (constraining consumption, substitutes) provided prices are allowed to play their signalling role.

By contrast, the history of government involvement in energy markets worldwide has often been characterised by waste and mismanagement. Politicians typically value votes more than the national interest. Political pricing has favoured some groups (eg households with voting power) over others, prices have been kept artificially low, thus encouraging demand growth and unnecessary investment, and government-owned energy businesses have been over-engineered, used as employment schemes, been slow to adopt new technology and yielded low returns. As we saw with Think Big and in the former Soviet Union, government intervention typically produces bad environmental outcomes as well as bad economic and social outcomes.

There are few 'market failure' problems in the energy sector that justify special government action, provided property rights are clearly determined and prices are allowed to reflect social opportunity costs. Global warming could be an exception, but both the scientific and the economic case for government action are far from established at this stage.

Summing up the debate about the case for intervention in energy markets, Cato Institute energy specialist Jerry Taylor wrote:

> Careful analysis reveals that, contrary to popular belief, energy is more abundant today than ever before; there is no wrenching scarcity on the horizon . . . Nor do free markets fail to provide for efficient energy use; the so-called market failures of the energy economy either do not exist or are more appropriately labeled "government failures." . . . Experience has shown that the invisible hand of the marketplace is far superior in providing for efficient energy use and conservation than is the dead hand of government planners.[3]

Taylor rightly derided the views of energy campaigner Amory Lovins who wrote "It would be little short of disastrous for us to discover a source of clean, cheap abundant energy because of what we might do with it", and Paul Ehrlich who said "giving society cheap, abundant energy . . . would be the equivalent of giving an idiot child a machine gun".

The best thing the government could do to promote energy efficiency on a sound basis in New Zealand would be to advance a number of strategies in areas where reforms have stalled in recent years. These would have beneficial economic and environmental impacts. Examples include:

- putting road management and operation on to a proper commercial basis with economic pricing including congestion charges;
- establishing market mechanisms to allocate water between energy-producing and other uses where water is scarce, through the development of water markets;
- clarifying property rights, especially in the case of Treaty of Waitangi claims, and investigating the possibility of privatising mineral rights;
- establishing competitive conditions in all markets through the removal of artificial entry barriers (eg restrictions on vertical integration in the electricity industry). In the absence of entry barriers, real concerns about the problem of so-called 'natural' monopolies are now few and far between;

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3 Jerry Taylor, 'Energy Conservation and Efficiency: The Case Against Coercion', *Policy Analysis* 189, Cato Institute, March 1993.

- privatising central and local government-owned energy businesses to increase their efficiency and ensure their pricing is subject to proper commercial disciplines, and improving governance processes in the electricity sector through industry cooperation; and
- promoting neutral taxation policies. For example, there is no sound case for excise taxes on petrol (in additional to GST and a road user element) or for a preferential regime for petroleum exploration and development.

Regrettably, the government seems disinclined to do most if not all of these things.

By contrast, there is no need for a national energy strategy, mandatory energy standards in the building code, capping electricity line charges, costly forms of information disclosure or an agency like the Energy Efficiency and Conservation Authority. New Zealand businesses and their industry associations should have the courage to debate which policies make sense and which do not; they should not simply go along with the politically correct ideas of the day.

At the commercial level, firms should of course pursue the normal role of business enterprises of striving to meet the needs of their consumers. If there is a profitable demand for more energy-efficient appliances, buildings or production processes, firms have every incentive to meet it: there is no need for government mandates. If 'green products' are sought after on local or world markets, firms should seek to exploit this new source of consumer demand. The evidence that consumers are prepared to pay a significant premium for green products is mixed, but undoubtedly a market exists for them.[4] If it grows, normal commercial incentives will ensure it is supplied efficiently.

Above all, we need to remember that in the energy sector, as in most others, sound economic strategies and sound environmental strategies are largely complementary. Richer is typically cleaner. A strong economy and high environmental quality mainly go hand in hand, as the experience of rich and poor countries alike demonstrates. If we sacrifice economic growth we are likely to end up worse off environmentally. There has to be clear evidence of market failure and evidence that government intervention will improve matters before it is wise to decide there is anything special about any market. In the case of energy, that evidence is by and large hard to find.

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[4] There is some evidence from the United States, particularly California, that some consumers are prepared to pay a little more to access 'green' energy – the best example is windpower.

UNIVERSITY OF WAIKATO MANAGEMENT SCHOOL
PUBLIC SEMINAR SERIES

FREE TRADE OR FAIR TRADE: WHAT'S BEST FOR NEW ZEALAND?

ROGER KERR
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NEW ZEALAND BUSINESS ROUNDTABLE

HAMILTON
8 AUGUST 2000

FREE TRADE OR FAIR TRADE: WHAT'S BEST FOR NEW ZEALAND?

Whenever New Zealand ministers for foreign affairs and trade comment on the World Trade Organization (WTO) or its precursor, the General Agreement on Tariffs and Trade (GATT), they always seem to make the same basic points. They emphasise that, as a small country, New Zealand needs access to large overseas markets if its industries are to prosper and provide job opportunities. They argue that GATT and the WTO have been vital to the promotion of a stable and secure trading system in which such market access can occur. They explain, that in the absence of international trading rules designed to prevent discrimination, small trading nations like New Zealand are more likely to be disadvantaged by agreements between larger, more powerful countries.

In the past there has been little public controversy about such statements, even though they do not deserve a score of 10 out of 10. A good reason for deducting marks is the insufficient recognition of the fact that New Zealanders benefit from international trade because it enables them to obtain much greater access to goods and services than would otherwise be possible. New Zealanders are disadvantaged by barriers that their own government imposes on imports as well as by the barriers that impede access to foreign markets.

The fact remains, however, that until recently very few people have seriously questioned the benefits that small countries like New Zealand obtain from efforts to foster the growth of world trade through the WTO.

This situation has now changed. The Ministry of Foreign Affairs and Trade (MFAT) reports that, in the first stage of public consultations on the proposed new round of multilateral trade negotiations, it received a number of submissions opposing further New Zealand involvement in the WTO or in a further negotiating round. Even though a majority of submissions supported promotion of the multilateral trading system, it is notable that some expressed doubts about "the success of the free trade model and its impact on employment and incomes, the environment, protection of human rights, and on developing countries". It is equally disturbing that another group of submissions argued that New Zealand should only agree to further trade liberalisation on a basis of strict reciprocity.

The recent questioning of the benefits of free trade in New Zealand seems to be inspired by the international campaign for so-called 'global fairness' that involved protests at the Asia-Pacific Economic Cooperation (APEC) summit in Auckland last year, followed by riots at the WTO meeting in Seattle later in the year and at a meeting of the World Bank in Washington this year. This campaign is an interesting example of the globalisation of interest group politics. The AFL-CIO, the peak US union body, has been actively establishing alliances with environmental, religious and student groups. Richard Trumpka, secretary of the AFL-CIO, recently travelled to Australia at the invitation of the central union body in that country with the message that "Seattle was just the start".

At one level it is not difficult to understand the notions of 'global fairness' that are currently being promoted by the international trade union movement and its allies. Their argument against free trade – or in favour of discrimination against foreign products – is simply the modern version of old-fashioned protectionism aimed at protecting the jobs of union members, usually in sunset industries, at the expense of new and more productive jobs. The responses of governments to this international campaign are more difficult to understand. As *The Economist* pointed out following the Seattle riots, "governments have not merely failed to make the case for free trade. They have pandered to their (unappeasable) critics, moved half-way to meet their demands and lent credence to their bogus fears".[1]

Unfortunately, the recent conduct of the New Zealand government has not been beyond reproach. In moving to put an end to unilateral tariff reductions, the government is obviously pandering to the critics of free trade. The acting minister of commerce stated: "We do not believe a small country like New Zealand can possibly gain from that process. New Zealand does not have the wealth or advantages of economies like Singapore and Hong Kong, China. Other countries are not flocking to follow our example".[2] Out of a possible score of 10, that statement deserves no more than zero. When Hong Kong and Singapore were relatively poor economies 30 years ago, they were much more open to international competition than New Zealand was at that time. The statement makes no sense, unless it is interpreted as an attempt to lend credence to bogus fears.

The case for free trade

The proposition that free trade promotes general economic welfare is one of the most robust findings in economics over the past 200 years. There is overwhelming support for this proposition among professional economists. In a survey of economists reported in the *American Economic Review*, only 10 percent of respondents disagreed that "tariffs and import quotas reduce general economic welfare". In a New Zealand survey only 6.5 percent of respondents disagreed with that statement.

Despite this, many people – including some political leaders – do not understand why free trade is beneficial. A statement made last year by Rod Donald, co-leader of the Green Party, serves to demonstrate a fairly common misconception. Mr Donald said:

> We are importing more and more products we should be making ourselves, thanks to the Government opening up our borders to unfair competition, causing jobs to disappear as well as increasing the trade deficit. You couldn't operate your home or business like this without going broke.[3]

This claim is simply wrong. At the household level, the equivalent of participation in international trade is participation in the market economy, rather than adopting a subsistence lifestyle. Most people participate in the market economy and use the income they obtain to buy goods and services. They do not try to produce all their own food or clothing or build their own houses or manufacture their own cars in their back yards. At various times in their life, for example when they buy a house or invest in higher education, most people run a trade deficit in their personal finances – they spend more than they earn. This rarely means that they are going broke. In most cases it means that they are laying the foundations for a more prosperous and secure future.

International trade involves mutually beneficial exchanges between people in different countries. Such transactions are beneficial to both parties for the same reasons that transactions between people in the same country are beneficial. If you value something owned by some other person more highly than they value it, there is scope for trade to occur. When the government intervenes to make transactions with foreigners more costly, it reduces the overall scope for citizens to gain from trade.

Specialisation is an important source of the gains from international trade. When countries specialise in the products they produce most efficiently and exchange them for products they produce less efficiently, they are able to sustain a higher overall level of consumption than would otherwise be possible. Potential gains from specialisation exist whenever there are differences in relative endowments of labour, natural resources or other factors of

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[1] 'Clueless in Seattle', *The Economist*, 4 December, 1999, p 17.

[2] Reported in *The Capital Letter*, 16 May, 2000.

[3] Statement dated 25 June, 1999.

production, or differences in relative efficiency across industries or activities. This is the principle of comparative advantage. Even if New Zealand were the most efficient producer in the world of every product, it would still gain from specialisation in the areas in which it is most efficient.

Another important source of the gains from trade is the influence of increased competition. The gains from trade estimated by using economic models that recognise the existence of imperfect competition and/or economies of scale are typically two-to-three times larger than those estimated by using models that assume perfect competition in all markets.[4] The role played by international competition in promoting efficiency is particularly important in small countries, where there may be only one or two producers of many products even in industries where size economies are moderate by international standards.

When people think of the benefits of international competition, the first thing that often comes to mind is reducing the potential for monopolists to exploit domestic consumers. The impact of international competition in encouraging international investment linkages and facilitating the international dissemination of technology and knowledge is also important and may have a greater influence on economic growth. International competition also has a pervasive influence on the strategies adopted by firms and the conduct of unions and regulators. Firms have a much stronger incentive to eliminate inefficient management and work practices when international competition makes it difficult for costs to be passed on by businesses to consumers. Unions and government agencies are also more likely to think twice about attempting to impose work practices or regulations that add unnecessarily to costs when this threatens the survival of firms and the jobs of the people employed by them.

A further benefit of trade liberalisation is the reduced incentive for 'rent-seeking'. When government ministers tell businesses that their doors are always open to those seeking protection against import competition, firms invest substantial resources to obtain these benefits. If investment in this activity occurs to the point where the additional cost is equal to the present value of the expected 'subsidy', there is potential for enormous quantities of resources to be wasted. In addition to corrupting political processes, this weakens the efficiency of firms by diverting managers from their commercial tasks. A rent-seeking culture also encourages the promotion within companies of people who have few skills other than knowledge of how to extract assistance from governments.

There is a strong body of empirical evidence of a positive relationship between the openness of trade regimes and economic growth rates. The results obtained from various studies differ to some extent depending on such things as the particular index of trade openness that is used in the analysis and the range of other policy variables included. After surveying this literature, the WTO concluded:

> Regardless of the index, estimation technique and time-period, the relationship between openness and growth is in most cases found to be positive, and when negative, statistically insignificant. There also seems to be a "virtuous circle" between trade liberalisation, growth and further trade liberalisation.[5]

Since the development of the infant industry argument for tariff protection in the nineteenth century, a substantial body of economics literature has sought to identify circumstances in which free trade may not be optimal. While the academic discourse has succeeded in qualifying and refining basic trade theorems, very few people involved in this analytical work would claim that any theoretical case for departure from free trade has much relevance to practical policy. Although many governments have made a lot of attempts over the years to draw on infant industry and more sophisticated arguments for

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4 WTO, *Annual Report 1998,* p 40.

5 WTO, *Annual Report 1998,* p 45.

government assistance to industries, the main result seems to have been to encourage further rent-seeking. Paul Krugman, a notable participant in the development of new trade theory, has argued:

> To abandon the free trade principle in pursuit of the gains from sophisticated intervention could . . . open the door to adverse political consequences that would outweigh the potential gains.
>
> It is possible, then, both to believe that comparative advantage is an incomplete model of trade and to believe that free trade is the right policy.
>
> In fact, that is the position taken by most of the free trade theorists themselves.[6] [7]

The old arguments for protection

One of the most common arguments against free trade, heard in New Zealand for more than a century, is that import barriers are needed to protect wage levels and/or preserve jobs. The argument implies that the impact on wage levels in wealthy countries of imports of labour-intensive goods from poor countries is akin to an expansion in the supply of unskilled labour in the former countries. In its most defensible form – based on the Stolper-Samuelson theorem – the argument is about the distribution of income. The proponents accept that average incomes would be higher under free trade, but argue that free trade would have undesirable effects on the distribution of income.

Over the years, this argument has had much more influence on economic policy than it deserves. For it to be taken seriously its proponents would need to establish empirically that competition from low-income countries actually has the potential to depress wages significantly in high-income countries. Then there is the question of whether trade protection is likely to be more efficient than alternative policies, such as policies to raise labour productivity, in improving the earning potential of wage earners.

Empirical studies on the issue of whether international trade is depressing wages of unskilled workers in developed countries suggest that factors other than increased trade with developing countries account for more than 75 percent of the observed increase in disparities between wages for the skilled and unskilled workers in developed countries in

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6 Krugman, P, 'Is Free Trade Passé?', *Economic Perspectives,* Vol 1, No 2, 1987, p 143.

7 Similarly, Jagdish Bhagwati in a speech in 1997 to the New Zealand Institute of International Affairs stated:

> The theoretical case for free trade has been well established; it goes back to Adam Smith and depends on positive concepts like comparative advantage and specialisation. Except for a few Neanderthals, nobody really challenges it any more. But the case for free trade is not just a theoretical case. In the last 50 years, we have had empirical confirmation . . . including detailed UN studies which take account of earthquakes, wars, and all kinds of local peculiarities. When the central is separated from the peripheral, which cannot be done in broad-brush cross-sectional regression analyses, the case for free trade stands undiminished.
>
> The case for free trade is not one which depends on arcane reasoning or the complexity of rocket science. The central core is a straightforward application of the argument that specialisation produces more output. In practice, compromises are inevitable. A lot still depends on judgment. I think ultimately policy is about what is practicable, not merely applying a theological case. The relevant ideas go back 200 years throughout the history of economics as a discipline. There have always been new thoughts, and proper professional doubts from time to time about the limits to standard arguments. There still are. But the compelling evidence is that the central tendency in the world is rightly captured by the central argument, what we teach in the elementary classroom, and not by qualifications created by the latest bright theorising. Basically, in the world of practical policy, the subtle qualifications do not really amount to a can of beans. If you want to bring prosperity to people, free trade is the way to do it.

recent decades.[8] The available evidence suggests that the effects of technological progress, particularly in increasing demand for skilled labour, have had a much greater impact on wage disparities.

Even if free trade increased significantly the gap between the wages of skilled and unskilled workers in high-income countries, it is unlikely that the real wages of unskilled workers would be lower under free trade. Unskilled workers, along with other members of the community, benefit from lower priced consumer goods. In addition, to the extent that free trade contributes to economic growth it tends to raise demand for all types of labour. A recent study by David Dollar and Aart Kraay of the World Bank (based on a sample of 80 countries with observations extending over four decades) provides strong support for the view that, just as a rising tide lifts all boats, economic growth tends to raise the incomes of the poor to about the same extent as it raises the incomes of other groups. This was found to be true of countries with both high and low incomes. The authors also looked at the effects of a range of different institutions and policies and found:

> Openness to international trade raises incomes of the poor by raising overall incomes. The effect on the distribution of income is tiny and not significantly different from zero.[9]

Another old argument for protection that continues to have some influence in New Zealand is the idea that a country is likely to disadvantage its citizens if it moves unilaterally to free trade while its trading partners continue to protect their industries. The errors of the argument have been exposed many times by eminent economists over more than 200 years. Adam Smith discussed the circumstances in which retaliation for foreign trade barriers might be beneficial. He wrote:

> There may be a good policy in retaliations of this kind, when there is a probability that they will procure the repeal of the high duties or prohibitions complained of . . . When there is no probability that any such repeal can be procured, it seems a bad method of compensating the injury done to certain classes of our people, to do another injury ourselves, not only to those classes, but to almost all the other classes of them.[10]

Paul Samuelson exposed the flaws in the argument in a different way in his well-known economics textbook:

> Some people admit that a world of free trade would be preferable to a world of tariffs. But they say that so long as other countries are so foolish or so wicked as to pass restrictive tariff legislation, there is nothing that we can do but follow suit in self-defence. Actually, however, a tariff is much like an increase in transportation costs. If other countries were foolish enough to let their roads go to ruin, would it pay us to chop holes in ours? The answer is, No. Analogously, if other countries hurt us and themselves by passing tariffs, we should not add to our own hurt by passing a tariff.[11]

Economic simulations that have sought to measure the extent of the benefits that individual countries are likely to obtain from multilateral trade negotiations have also demonstrated the fallacy of counting the reduction in our trade barriers as a cost that is only justified if we obtain reciprocal benefits in the form of greater market access. Such simulations suggest that the countries that made the largest liberalisation commitments in

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8 See, for example, WTO, *Annual Report 1998,* p 49 and W Cline, (1997), *Trade and Income Distribution,* Institute for International Economics, Washington, p 257.

9 Dollar, D and Kraay, A, (2000), *Growth is Good for the Poor,* Development Research Group, World Bank, Washington, March.

10 Smith, A, (1981), *An Inquiry into the Nature and Causes of the Wealth of Nations* (Vol 1, IV ii, 39), Liberty Classics edition, Indianapolis, p 486.

11 Samuelson, P, (1958), *Economics,* McGraw-Hill, New York, p 678.

the Uruguay Round will also experience the largest gains.[12] A recent Organisation for Economic Cooperation and Development (OECD) study of the potential impact of a further round of trade liberalisation concluded:

> What these various estimates show is that by just cutting tariffs, the net benefits are not only substantial, but equally importantly they are distributed evenly across countries and groups. Every single country or group of countries stand to benefit from tariff liberalisation with the benefits proportionate to the degree of liberalisation.[13]

All the talk about reciprocity and exchange of 'concessions' that traditionally surrounds international trade negotiations tends to obscure the fact that the benefits that individual countries obtain from such negotiations come to a large extent from reductions in their own trade barriers. In a recent presentation to the WTO, Gary Banks, chairman of the Australian Productivity Commission, argued that the principle of reciprocity actually tends to confuse the issues involved in trade liberalisation. He said:

> Reciprocity at its best has successfully enabled multilateral liberalisation to proceed – as post-war tariff history attests – but there is a corrosive element at its core. It undermines domestic understanding of the true source of gains from national liberalisation.

Banks went on to suggest that the principle of reciprocity also tends to undermine the authority of the WTO in disputes because "a decision which goes against a country is automatically seen by the defending country's community as harming its national interests, which is not necessarily (indeed rarely) the case".[14]

Those arguing that further tariff reductions in New Zealand should only take place in exchange for reciprocal concessions should also take some notice of the recent views of the Australian Department of Foreign Affairs and Trade (DFAT) – an organisation that has a strong interest in opposing any strategy that would weaken Australia's negotiating position. DFAT has argued that because international tariff negotiations are normally in terms of 'bound' tariffs rather than 'applied' tariffs, further unilateral tariff reductions could actually strengthen Australia's negotiating position by allowing Australia to offer bigger cuts in bound tariffs. DFAT also argued that future trade negotiations are likely to give credit to countries that unilaterally reduce their tariffs, based on the precedent established in earlier multilateral trade negotiations.[15]

The globalisation debate

One of the important driving forces behind globalisation is a continuing fall in the costs of transport and communications. In the nineteenth century, railway transport reduced the costs of trading goods by 85 to 90 percent. Steam ships and new navigation channels reduced both the costs of maritime transport and the time required to freight goods. The costs of international transport continued falling in the twentieth century, particularly with the advent of air transport. And as everyone knows, communications costs also fell dramatically during the last century and are expected to continue to fall.

However, the trade policies of governments have played the crucial role in determining the extent of globalisation. Over the period from 1913 to 1950, international trade fell substantially as a proportion of gross domestic product (GDP) in the major countries. Even

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12 WTO, *Annual Report 1998*, p 52.

13 OECD, *Non-*'OECD' *Countries and Multilateral Trade Liberalisation: A background note on some key issues*, TD/TC(99)18/FINAL, November, 1999.

14 Banks, G, 'Trade Liberalisation as a Domestic Issue: The role of Australia's Productivity Commission', speaking notes for a presentation to the WTO, Geneva, March 2000.

15 DFAT submission to Australian Productivity Commission, reported in: Productivity Commission, *Review of Australia's General Tariff Arrangements*, draft report, Canberra, 2000.

though trade has grown more rapidly than world GDP since 1950, this has not done much more than restore the trade to GDP ratio that existed prior to World War I. The reason why the trade to GDP ratio did not move back quickly to earlier levels during the 1950s has a great deal to do with protectionist policies adopted during the 1930s that were liberalised only gradually – and at varying rates in different countries – during the post-war period.

The existence of high trade barriers for most of the twentieth century shows how wrong it is to see globalisation as some kind of monster that has progressively come to dominate national governments. The real monster is trade protectionism. Governments were largely responsible for unleashing this monster during the 1930s. It was not long before government policies came to be strongly influenced by interest groups that benefited from trade protection. Even though many governments have been fighting protectionism for more than half a century, the recent outbreak of globophobia suggests that this battle is not yet over.

Recent history has provided strong evidence that globalisation has had a marked positive impact on income levels in those countries that have participated fully in the global economy. Conversely, those countries that have not participated in the mainstream of the world economy are among the world's poorest. The Secretary-General of the United Nations Conference on Trade and Development (UNCTAD) commented as follows in 1998 in a report on the least developed countries (LDCs):

> Not only have LDCs' growth rates lagged behind those of other developed countries but also their share of world exports and imports has fallen sharply. LDCs have attracted a negligible share of global flows of foreign investment and remain heavily dependent upon official development assistance to finance a large share of their investment.[16]

Globalisation has improved the living conditions and prospects of hundreds of millions of people over the past 30 years. The Asian scholar Christopher Lingle comments as follows on the experience of economies in Asia and Latin America:

> What has been learned is that globalisation has been the most effective liberalizing process in the history of mankind. Such a claim might cause Karl Marx to roll over in his grave and induce apoplexy in his diehard disciples. But history speaks for itself. International capital flows and greater trade integration over the past three decades have lifted nearly half a billion people out of poverty, mostly in Asia.
>
> Global trade and capital flows are forcing governments to be more accountable to their people, who wish nothing more than to be able to prosper.[17]

Work by the Cato Institute's Center for Trade Policy Studies has demonstrated a strong correlation between political freedom and economic openness. The results of these studies imply, according to Aaron Lukas, that "citizens who enjoy the freedom to engage in international commerce are about four times more likely to be free from political and civil oppression than those who do not enjoy such freedom".[18]

The modern opponents of free trade often argue that globalisation involves a 'race to the bottom' in terms of environmental standards and government provision of social safety nets. These opponents fear that freedom of trade and international capital flows will put pressure on individual countries to sacrifice such standards in order to gain competitive advantage over one another in attracting capital. In fact, studies have found little evidence

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16 UNCTAD, *The Least Developed Countries 1998 Report Overview,* United Nations Conference on Trade and Development.

17 Lingle, C, 'Economic Growth and Freedom in the Coming Millennium,' *Ideas on Liberty,* April 2000, p 36.

18 Lukas, A, (2000), *WTO Report Card III, Globalization and Developing Countries,* Cato Institute, June.

to support the proposition that capital is responsive to differences in environmental standards. Jagdish Bhagwati has suggested that there are many ways to explain this lack of responsiveness, including the possibility that lower standards may repel, rather than attract foreign direct investment.[19] While a lowering of environmental standards may attract a firm to invest in a polluting industry, this can deter investment in other industries that may rely, for example, on clean water or air.

There is no reason to expect any government to participate in a 'race' to adopt inequitable or inefficient policies unless they are acting on behalf of narrow economic interests rather than the general population. When we look around the world, it is obvious that such crony capitalism (and crony socialism) is more commonly associated with trade protectionism than with free trade policies. If a government is prepared to sacrifice the interests of domestic consumers by offering increased tariffs to protect profits or employment in particular industries, no one should be surprised if it is also inclined to sacrifice the interests of the public on environmental and other issues in order to promote its links with particular firms or sectors of industry.

Some people argue against globalisation on non-economic grounds. Local cultures, for example, are said to be imperilled by the irresistible force of American culture. Hollywood's importance in world cinema is often cited as an example. This is indeed an example of globalisation, but hardly an example of American domination. From the earliest days Hollywood has been open to foreign talent and foreign investment. Looking beyond cinema, local cultures seem to be able to hold their own very well against international competition. *The Economist* has cited the following examples:

(a) In every European country in 1997, the most popular TV program was a local production;

(b) No foreign song has ever stayed more than three weeks in the Japanese charts, except Frank Sinatra's rendition of "My Way";

(c) Britain's Spice Girls were successful in Norway only when the soundtracks were removed from their videos;

(d) Over 95% of Germans born before 1945 insist that they have never heard of any British writer except Shakespeare (and 20% of them think Shakespeare was German).[20]

Cultural protectionism can be as malign as economic protectionism. Openness to the outside world may be the best hope for ridding countries of cultural practices such as female circumcision and footbinding. Cultures often change because people become exposed to new experiences that they value. No one is forcing breakdancing, Britain's Teletubbies, Irish music or Pokemon on the youth of the world.

Those who chant "No, no to the WTO" seem to be particularly concerned about the potential for WTO rules and dispute settlement procedures to constrain national sovereignty. Jane Kelsey of the University of Auckland has argued that the WTO "fundamentally affects the capacity of New Zealand governments to determine and implement domestic economic and social policy".[21] This is nonsense. We belong to the WTO because it serves New Zealand's overall interests and we are free to leave tomorrow. Mike Moore does not have a fleet of gunboats at his command to force countries to become members the WTO. When we become party to an international agreement we cannot expect to be free to take action that would undermine the agreement under the guise of pursuing some environmental or social objective. But if we so wished there is nothing to stop New Zealand following the policies of Cuba, Myanmar, North Korea, Libya or Iran, or

19 Bhagwati, J, (1995), *Free Trade, 'Fairness' and the New Protectionism,* Institute of Economic Affairs, London, p 21.

20 *The Economist*, 18 December, 1999, p 110.

21 Article in *The New Zealand Herald,* 1 December, 1999.

indeed reverting to the former inward-looking policies that brought the country to its knees.

The anti-WTO movement seems to be inconsistent on the question of national sovereignty. The protestors argue that pursuit of free trade should not be allowed to impinge on the national sovereignty of countries imposing import restrictions. However, they have no hesitation in disregarding the national sovereignty of other countries in the name of 'fair trade' when it comes to things like labour and environmental standards.

What is fair trade?

People who are in favour of fair trade might be expected to show some concern that developing countries face tariffs on their manufactured exports that are nearly four times as high as those facing exports from industrial countries. Instead, those involved in the recent campaign for global fairness seem to view trade between high wage and low wage countries as intrinsically unfair. First, they argue that it is unfair to workers in the high wage countries because they are being undercut by sweatshop labour. Second, they argue that it is unfair to workers in low-wage countries because they are being exploited. *The Economist* has suggested:

> The best answer to both arguments is simply to point out that, 'fair' or not, trade raises incomes in both countries. Victims of injustice and exploitation should always be so lucky.[22]

Even in the case of child labour, views of what is fair will differ from country to country. We would consider it grossly unfair if some New Zealand children were unable to attend school because they had to work to supplement family incomes. Our views on child labour might be different, however, if the alternative for the children concerned was not education but malnourishment or prostitution – as in some poor countries. It would be strange indeed to penalise poor countries by taking measures that would make many of their citizens worse off.

Should WTO rules permit members to use discriminatory trade barriers against countries that are obtaining an 'unfair' advantage in trade by following labour or environmental practices that some people in high-income countries regard as unacceptable? While this may appear to be a reasonable approach, there are at least three reasons why no one should rush to endorse such proposals:

- Unanimity about what specific labour and environmental practices are acceptable cannot be expected. What is acceptable depends on the alternatives available to poor countries. It also depends in many cases on moral judgments that are unlikely to be unanimous. The morality of using governmental coercion – eg through trade and investment bans – in such situations has to be questioned. People can make their own decisions as to what is acceptable or not in their roles as consumers and investors.
- The concern of many developing countries that permitting the use of trade restrictions to influence production methods in other countries would open the door to protectionist abuse cannot be lightly dismissed. There are interest groups in many countries that would welcome another way to seek protection from import competition.
- Using trade barriers is not likely to be the most effective way to eliminate undesirable practices. Trade sanctions are only effective when a large number of countries agree to participate. Alternatives such as diplomacy, exposure to international media, education and conditionality clauses in development assistance are likely to be more effective in many cases.

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22 'The miracle of trade', *The Economist,* 27 January, 1996.

Senator Peter Cook, the shadow minister for trade in Australia, has made a calculation of the proportion of imports to that country that would be affected if a 'social tariff' were to be imposed on imports from countries that transgress International Labour Organisation (ILO) conventions. The figure for countries that have been found to breach the core labour standards is 37 percent of all goods imported to Australia. Of the 51 countries judged by the ILO as failing to live up to their obligations, 12 are members of the OECD. Mr Cook concluded that an attempt to impose a 'social tariff' would greatly disadvantage Australian consumers, particularly low-income earners. This has prompted Australian Labor MP, Craig Emerson, to ask: "What is 'fair' about requiring poor families to pay exorbitant prices for basic items, such as clothing, shoes and car transport, which are so vital to obtaining and keeping a job?".[23]

Conclusion

There is no need for New Zealand to choose between free trade and fair trade. Free trade is fair – according to any commonly accepted standards of fairness. International trade is based on mutual benefit to both buyers and sellers. It enables most people in participating countries to maintain much higher standards of living, including environmental standards, than would otherwise be possible. The former communist countries had no free trade and the worst environmental standards. People living in countries with liberal international trade regimes tend to enjoy greater political freedom, as well as greater economic freedom, than those living in countries with high trade barriers.

By contrast, trade restrictions are generally unfair. Trade restrictions imposed by wealthy countries tend to discriminate unfairly against poor countries. When governments impose trade restrictions they also discriminate unfairly among citizens of their own countries. Those who benefit from the restriction of competition are advantaged at the expense of the rest of the population who have to pay higher prices for goods and services. The distribution and level of trade barriers are typically determined by the exercise of political influence rather than by principles that have regard for equity or efficiency. This results in the corruption of politics as well as the impoverishment of citizens.

New Zealanders have a creditable record of efforts to help improve the lot of poor people in other countries. If we want to retain that reputation, we should distance ourselves from the confused thinking or hypocrisy of politicians, academics and trade unionists who pretend to be concerned about 'global fairness' while advocating tighter import restrictions that would further disadvantage the poor. In Seattle it was the governments of the poor countries that were ranged against the protesters from the rich ones – they wanted a broadly based negotiating round to proceed. Similarly, if we want to have a positive influence on the world environment, we should follow policies that enable our objectives in that area to be achieved without causing unnecessary damage to the international trading system and the well-being of the countless millions who depend on it. In addition, richer is ultimately also cleaner.

Free trade is the best policy for New Zealand, irrespective of what other countries may do. We should not allow ourselves to become diverted from free trade by the red herring of reciprocity. There is no basis for the argument that a unilateral move to free trade would weaken our negotiating position in future international trade negotiations. New Zealand should resume its move toward free trade without further delay.

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23 Emerson, C, 'Fair trade does not represent a fair go', *Australian Financial Review,* 29 June, 2000.

NEW ZEALAND AGRIBUSINESS AND FOOD CONGRESS

COOPERATIVES VERSUS CORPORATES

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

CHRISTCHURCH
9 NOVEMBER 2000

COOPERATIVES VERSUS CORPORATES

It is important to be clear what we mean when we talk about competition between supplier-owned cooperatives and investor-owned corporates. The competition between forms of business organisation is not like a sporting competition where there is only one prize and one winner and players are not allowed to switch teams in the middle of a game. Business competition may take place between firms that are organised in different ways and result in changes from one form of business organisation to another.

Although investor-ownership is the clear winner in a large swathe of economic activity, cooperatives and non-profit firms have important advantages in some situations. There is likely to be ongoing competition in industries or markets where cooperatives and investor-owned firms are fairly evenly matched. An important issue is whether changes occurring in agricultural processing and marketing are more likely to favour cooperatives or investor-owned firms.

It should go without saying that cooperatives and investor-owned firms ought to be allowed to compete on equal terms, without the government intervening to favour one way of doing business relative to the other. Unfortunately, as recent restructuring proposals for the dairy industry have shown, our government still bends to pressure to favour cooperatives relative to investor-owned firms in the processing and marketing of agricultural products. The strong ideological attachment to cooperatives in some quarters in New Zealand is arguably holding the sector back.

What is so special about cooperatives?

It is difficult to understand why this ideological attachment to cooperatives lingers on. Cooperation is a good thing in any business, but there is not necessarily anything more cooperative about the business organisations that we call cooperatives than about investor-owned firms. Some advocates of cooperatives like to think of them as "people-centred businesses".[1] This conveniently overlooks the fact that all inputs to firms – including capital – are provided by people. In addition, like the owners of investor-owned firms, the owners of cooperatives benefit from any profits made by them. In neither case is the primary purpose of the business altruistic, as may be the case in non-profit firms.

The chief executive officer of the New Zealand Cooperatives Association, Ian Reid, has defined a cooperative as "a collection of individuals or businesses that decide to operate together for advantage".[2] People also operate together for advantage in investor-owned firms – indeed they are a type of producer cooperative. This is the view of Henry Hansmann, a Yale law professor who has made significant contributions to economic analysis of the ownership of firms. Hansmann points out that in any producer cooperative, the suppliers of one of the factors of production receive any residual earnings after suppliers of other factors of production have been paid. An investor-owned firm is a type of producer cooperative in which suppliers of capital have the rights to residual earnings after suppliers of raw materials, labour and other inputs have been paid.[3]

In practice, because the cooperatives owned by farmers in New Zealand do not obtain all their capital by borrowing, farmers have had an important role as suppliers of equity capital to these firms in addition to their role as suppliers of raw materials. The growing requirement for equity in value-added processing poses a critical issue for the farmers who

1 For example, this term was used by Edgar Parnell, director of the Plunket Foundation, in *Australian Dairy Cooperatives: Planning for the Future,* Dairy Research and Development Corporation, February 1996, p 74.

2 As reported in *The Dominion,* 24 September, 1999.

3 H Hansmann, (1996), *The Ownership of Enterprise,* Harvard University Press, Cambridge Massachusetts and London, England, p14–15.

own these firms, namely how to raise sufficient capital at least cost when their ownership rights, stemming from their role as suppliers of capital, are fused with their rights as suppliers of raw materials. As discussed later, it is becoming increasingly untenable to attempt to avoid this issue by bundling returns on the capital supplied by farmers together with payments for the raw materials they provide.

Why is investor ownership the norm?

Ownership of firms by the suppliers of equity capital is the norm in capital-intensive industries in New Zealand, as in most other economies. This is evident from the fact that investor-owned companies are frequently referred to as corporates and the system of private ownership is often referred to as capitalism.

Investor ownership has not become the norm as a result of an accident of history. There are good reasons why ownership of firms by specialised suppliers of capital is superior to the alternatives, particularly when the capital requirements of the firm are beyond the capability of its managers and suppliers. Although some of these reasons are familiar, it is worth listing them to make the point that only in special circumstances are other forms of ownership likely to be more efficient.

- First, the corporate structure permits the separation of investment and ownership from the management role. It allows the firm to tap into capital markets, now global in nature, for equity capital rather than having to rely an internal resources or on debt.
- Secondly, providers of capital are commonly in a much better position to bear the risks associated with the role of residual claimant because they are able to reduce firm-specific risk. Investors can hold a diversified portfolio of investments rather than having a high proportion of their capital invested in one firm. The capital market provides greater liquidity for small investors, which reduces the cost of capital to firms.
- Thirdly, as owners, investors generally share a single well-defined objective: to maximise the net present value of the firm's earnings. Sharemarket listing provides visible and independent valuations of future profits. This tends to reduce the costs of collective decision making in investor-owned firms.
- Fourthly, open capital markets provide mechanisms and disciplines that limit the problem of the separation of ownership and control. Owners and managers can have different interests. This problem arises with both corporates and cooperatives. Sharemarket listing, however, helps owners to monitor the performance of firms' managers. Large block shareholders have particular incentives and, typically, expertise to perform this role. They may also bring other benefits such as operating synergies, technology and access to markets. Remuneration arrangements involving share parcels and options can help align the interests of managers with those of owners. Sharemarket listing provides greater potential for the threat of takeover to act as a spur to managerial efficiency.[4]

There are some circumstances in which cooperatives may offer efficiency benefits that more than offset the advantages of investor ownership. (For convenience I use the term 'cooperative' in the conventional way from here on to refer to ownership by some class of patrons other than investors.) For example, where transaction-specific investments are involved, farmers may suffer a capital loss if the processing firm decides to obtain supplies from some other source, or the processing firm may suffer a capital loss if farmers decide to

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[4] It should be noted that whatever the structure of ownership, it is possible for the control of a firm to change hands if existing owners are prepared to sell. Conversely, unless the owners of a controlling share are prepared to sell at the offered price, there is no way that any takeover offer can succeed.

sell their produce elsewhere or to produce something else.[5] Such problems can be serious, but control of the firm by some group of patrons other than investors is not necessarily the best solution. In many instances this type of problem can be handled adequately through contractual arrangements.

The strongest argument that cooperatives are efficient is their ability to operate successfully in a competitive market. If both investor-owned firms and cooperatives are doing so at a point in time, the efficiency of both forms of organisation must be roughly equal. This seems to be the case, for example, for retailer-owned wholesale cooperatives, such as Foodstuffs. This type of cooperative has also been able to compete successfully in the United States and Australia.

Agricultural supply cooperatives are also common in dairy processing and some other industries in the United States and Australia, as well as New Zealand. It is not always clear, however, that this implies that cooperatives are as efficient as investor-owned firms in these industries. Several factors need to be taken into account:

- In New Zealand, single desk exporting has virtually precluded entry of investor-owned firms to compete with cooperatives in the processing of dairy products for export. Overseas evidence that some dairy cooperatives have been able to hold their own in competitive environments has little relevance to the performance of cooperatives in a situation where competition is precluded. The proposed linking of the removal of the Dairy Board's export monopoly to the establishment of a mega-cooperative could result in the industry remaining protected from competition from investor-owned firms. The New Zealand Business Roundtable has opposed the mega-coop proposal because of its potential to impede the access of competitors to milk supplies by denying its shareholders the right to exit with the full value of their equity.
- The overseas evidence on the competitiveness of agricultural supply cooperatives is not clear-cut. It is arguable that the exemption of cooperatives from antitrust law, in combination with regulatory advantages, has tended to favour cooperatives relative to investor-owned firms in the dairy industry in the United States.[6] In addition, the corporate tax regime in the United States has tended to disadvantage investor-owned corporates relative to cooperatives.[7]
- There seems to be a tendency for successful agricultural supply cooperatives to behave less like cooperatives and more like investor-owned firms, the further they extend their range of activities or add value to raw materials. If the cooperative is engaged solely in bargaining and the equity of owners is negligible, there is no reason why the owners of the cooperative cannot exercise their ownership rights solely with regard to their role as raw material suppliers. However, where the firm is engaged in value-adding activities that require substantial capital, the cost of capital to the firm is likely to be prohibitive unless the owners have substantial equity. As the value of owners' equity increases, the 'custodial' concept of ownership tends to get left by the wayside. It becomes increasingly untenable to allow new members to purchase shares at a nominal price and to provide retiring members with nominal compensation for the surrender of their shares.

Despite these qualifications, it is probable that agricultural supply cooperatives would have been able to survive open competition from investor-owned firms in some industries without government assistance. However, this is not necessarily a good guide to the future competitiveness of cooperatives in these industries.

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5 The issues involved in ensuring that farmers have a secure outlet for product are discussed more extensively in W Bates, (1998), *Farmer Control of Processing and Marketing, Does it serve the interests of farmers?*, New Zealand Business Roundtable, Wellington, August, pp 28–35.

6 Christopher Wolf and Larry Hamm, 'The role of cooperatives in milk marketing', paper presented to the American Agricultural Economics Association annual meeting, 1998.

7 H Hansmann, *The Ownership of Enterprise, op cit*, p 131.

Is there a trend away from cooperatives?

Some advocates of agricultural cooperatives seem to delight in pointing out that the New York Stock Exchange functions as a cooperative. If this is relevant, it is perhaps also worth noting that the Australian Stock Exchange (ASX) converted last year to become a listed company owned by investors. Other stock exchanges, including Wall Street and the New Zealand Stock Exchange, may follow suit. There has also been a trend toward investor ownership in other areas where the cooperative or mutual form has traditionally been important, including insurance and health services.

In agricultural processing and marketing activities in New Zealand, Australia and some other countries, there seems to be a fairly clear trend toward investor ownership. One important New Zealand example is AFFCO, a major meat processing firm, which converted from a cooperative to a listed company in 1995. By providing for shares to be traded on a restricted basis, recent reform proposals for the dairy, apples and pears, and kiwifruit industries may be interpreted as a step in the direction of investor ownership, albeit a small and reluctant step.

In Australia, the trend in recent years toward stock exchange listing of farmer cooperatives has been attracting headlines like: "Bush goes on the bourse". In the dairy industry, early moves in the direction of investor ownership were made when Dairy Vale, a dairy products group based in South Australia, was floated on the ASX in 1995. Despite an elaborate structure designed to avoid takeover, a successful takeover occurred last year. Because the purchasing firm, Dairy Farmers, is a major cooperative, this might be thought to have levelled the score. However, Dairy Farmers is itself now considering a restructuring proposal that involves listing on the sharemarket within three years.

Meanwhile, Parmalat, a privately owned firm that is a major player in the international dairy market, has made a merger offer to Dairy Farmers. Some of the shareholders in Dairy Farmers clearly consider this offer to be more attractive than the restructuring proposal that their board has put to them. The Supreme Court of New South Wales has recently found that some of the material that the board of Dairy Farmers sent to its shareholders urging them to ignore Parmalat's merger offer was misleading or deceptive. Whatever the outcome of this particular merger proposal, it is clear that Parmalat would like to expand its Australian operations further, following its purchase last year of Pauls Limited, a Queensland dairy company. It is interesting that one of Parmalat's reasons for expanding in Australia is to obtain access to dairy products to sell to Asia. I expect that many Australian dairy farmers agree with the chief executive of Parmalat's Australian operations, Alberto Ferraris, when he says that supplying Canadian cheese to Asian clients, as his firm has done in the past, is "sub optimal".[8]

The large Victorian company, Bonlac Foods, has moved a considerable distance in recent years in the direction of becoming an investor-owned food and beverages company, rather than a traditional dairy cooperative. Through the acquisition of Spring Valley, it has expanded its activities beyond dairy products to include fruit juices and other beverages. Although Bonlac's core business has not been listed on the ASX, it launched a $100 million issue of listed capital notes in mid-1988 to reduce debt and fund acquisitions.

The introduction by the ASX in 1997 of more flexible listing guidelines that covered cooperatives and former cooperatives has led to the listing of several firms. Farm Pride Foods Limited, formerly the Egg Industry Cooperative Limited, was the first company to be listed under the new rules. In 1998, PLC Industries, a major egg marketer and feed miller, also converted to a public company, with 83 percent of shareholders voting in favour. The New South Wales grain handling company, Graincorp, was listed in March last year. Grain handling cooperatives in other states are reported to be considering similar

[8] Reported in the *Australian Financial Review,* 5 October, 1999, p 25.

moves. The national wheat marketing firm, AWB Limited (formerly the Australian Wheat Board), is planning a stock exchange listing for the middle of next year.

Turning to fibres, Namoi Cotton was listed in 1998. Woolstock Australia Limited, the private farmer-owned company that owns the remnants of the wool stockpile – which was accumulated under the infamous reserve price scheme that collapsed over eight years ago – is also reported to be considering listing on the ASX. It is possible, however, that the stockpile could be sold in a single deal before ASX listing occurs.

It is easy to overlook the fact that Wesfarmers, an industrial conglomerate with an annual turnover of around $3 billion – which makes it one of Australia's largest public companies – is controlled by the Westralian Farmers Co-operative Limited. This cooperative owns a 'founders share' in Wesfarmers as well as nearly half of its issued capital. Despite this, the management of Wesfarmers has been characterised by a strong focus on improving shareholder value. It is not surprising, therefore, that the chairman of Wesfarmers has publicly flagged the possibility that, as part of some future merger of the agricultural activities of Wesfarmers with other agricultural companies – such as AWB Limited – the cooperative that currently has a controlling interest in Wesfarmers might cease to exist.

There is also a strong trend toward conversion of agricultural cooperatives to public companies in some other parts of the world. Three major Irish dairy cooperatives led the way about 10 years ago. The Kerry Group is often held up as a model of the benefits of corporatisation. Since its public listing in 1986, Kerry Group has grown into a major international food business with interests extending into areas such as meat products, convenience foods, home baking products and food ingredients. As in the case of Wesfarmers, a cooperative structure initially held a majority shareholding in Kerry Group but with the rapid expansion of the company the proportion of shares owned by the farmer cooperative has fallen substantially. The success of Kerry Group's operations has led to around a 20-fold appreciation in the company's share price.

It would not be correct to imply that the advantages of the corporate form are seeing an inexorable trend toward conversion of agricultural cooperatives to public companies. There is the potential for conflict between public shareholders and cooperative members when cooperatives attempt to maintain the business practices of a cooperative while raising equity capital from the public. Some agricultural cooperatives that have experimented with public listing, including a subsidiary of the large US dairy cooperative Land O'Lakes, have subsequently reverted to 100 percent ownership by a cooperative.

What are the pressures on agricultural cooperatives?

In a speech I gave a couple of years ago, I observed that the same factors that had been driving demutualisation in the insurance industry were also placing agricultural cooperatives under pressure to convert to publicly listed companies.[9] These factors were: an increase in the range and diversity of activities of cooperatives; growing capital requirements; and the pressures for greater accountability for performance in a more competitive environment.

Range and diversity of activities

There are strong economic pressures for firms engaged in processing and marketing of agricultural products to undertake a wider range and diversity of activities. Traditional specialisation on commodity lines is under challenge. There is often potential to achieve economies by selling a range of beverages, for example, rather than just dairy products, or a range of horticultural products, not just apples and pears or kiwifruit. In addition, the

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9 R L Kerr, 'Whither Cooperative Dairy Companies', published in *The Trouble with Tea Breaks*, New Zealand Business Roundtable, Wellington, March, 1998.

increasing demand for convenience foods can often be met more readily by diversified food manufacturing firms.

As cooperatives attempt to meet this challenge by diversifying and adding more value, the returns flowing to farmers come to depend to an increasing extent on investments in activities that are a long way removed from the farm gate. As this trend continues, it is likely that more members of cooperatives will question why their capital is being placed at risk in investments that are not directly related to the processing and marketing of their produce. Cooperatives are likely to find it increasingly difficult to compete with firms like Kerry Group and Nestlé that are not similarly constrained.

The problems are exacerbated by the practice of bundling the dividend component of the return paid to farmers in the price they are paid for the produce they supply. Sending out separate cheques for dividends and produce will not solve the problem. The problem will remain as long as suppliers of produce are required to own shares proportional to the quantity of raw materials they supply. In other words, the bundling problem will only be solved when those farmers who wish to do so are free to sell their shares while continuing to supply raw materials to the firm.

Access to capital

Capital raising is likely to become an increasing problem as cooperatives get further involved in additional value adding. As residual claimants, farmers alone must assume nearly all the investment risk associated with cooperatives. As the amount invested in cooperatives by individual farmers increases relative to the level of their total assets, the risks involved in further investment must ultimately rise sharply. Although some external finance can be borrowed by farmers or cooperatives or both, prudence dictates that debt be kept in balance with the equity available from retained earnings.

What this means is that the ability of cooperatives to fund expansion is limited by the willingness of farmers to accept lower payouts in order to establish reserves. This can prevent cooperatives from becoming involved in major new investment projects, including the acquisition of major international brands, other than through joint venture arrangements with investor-owned firms.

Accountability

Accountability for performance tends to become an increasing problem as cooperatives become larger and as they diversify their activities. It is arguable that supplier shareholders in a small, local cooperative have common interests, are well placed to monitor its management, and have a fairly strong incentive to be well informed about its activities. As the membership of cooperatives increases and their activities become more diverse, the interests of members tend to diverge, individual members have less influence over decisions and it becomes much more difficult for them to monitor performance. Where a cooperative is heavily involved in further value-adding activities, members are likely to be less well placed to monitor the efficiency of the firm than are professional investors such as fund managers. In addition, in the context of a regulatory environment that has discouraged entry of investor-owned firms, the amalgamation of cooperatives in an attempt to achieve size economies tends to eliminate competitive benchmarks that could be used to assess the relative efficiency of different firms. This means that where members of a cooperative suspect that the firm may be poorly managed they are often unable to withdraw their investment unless they are prepared to change their occupation. The problems of dispersed ownership and the absence of benchmarks are likely to be serious in the case of the proposed dairy mega-coop if it proceeds.

When regulations that have discouraged entry of investor-owned firms, particularly single desk exporting, are finally removed, agricultural cooperatives will come under increasing pressure to lift their performance. Many may conclude that the advantages of investor ownership listed earlier are compelling reasons for converting to publicly listed companies.

Transferability of shares

An additional factor that is likely to place agricultural cooperatives under increasing pressure is the desire of members to ensure that they and their families can obtain access to the capital built up in cooperatives without having to sell their farms.

Under the traditional custodial concept of ownership of cooperatives, the benefits of the cooperative were capitalised in land values and accrued whether or not farmers actually supplied produce to the cooperative. There was no requirement to make a substantial investment in share purchase on entry to the cooperative and no compensation on exit for capital left behind. In those circumstances, investments made by the cooperative conferred benefits to current members that were more or less equivalent to an increase in the price received for farm produce.

The benefits of ownership accrue more directly to members when compensation is paid for shares relinquished when members leave the cooperative. However, the compensation payable is generally determined according to the value of the tangible assets of the firm. The value placed on a firm by the sharemarket reflects the present value of the expected future earnings of the firm as an ongoing concern. The market value of listed companies is usually substantially greater than the value of their net tangible assets.

In addition, farmers have to cease to be suppliers in order to obtain access to their share of the capital that accumulates in cooperatives. In some respects this is similar to a form of compulsory superannuation that can only be accessed on retirement, no matter how much the owner of this asset may prefer to use the funds for other purposes such as repayment of debt or education of children. The situation is actually much worse than this, however. A well-designed superannuation fund would not require farmers to put all their eggs in one basket by investing large sums in a single firm, particularly when returns from that investment are likely to be highly correlated with returns from the farm itself. Nor would such a fund treat particular classes of investors, such as long-established savers and new savers, in an arbitrary manner, as cooperatives commonly do.

While many farmers now recognise the benefits of being able to transfer ownership rights, there is still some concern that unrestricted share transfer could disadvantage them by resulting in a loss of farmer control. It is common for some restrictions on share transfer to be retained in initial public share offerings in order to ensure that farmer control of firms is not threatened.

It is possible that these restrictions may deny shareholders of poorly performing firms the potential to achieve higher future earnings through transfer of control. Even with these restrictions, however, successful takeover offers can still be made when large numbers of farmers are prepared to sell their shares.

The main cost of restrictions on share transfer takes the form of a lower market price for farmers' shares because liquidity is reduced. When there is a requirement that a certain class of shares must be owned by farmers, any farmer selling shares has to sell at a price at which it is attractive for some other farmer to buy. In order to induce farmers to hold more of these shares in their portfolios the yield must be higher (or the share price must be lower) than on shares that are freely tradeable. Shareholding restrictions also reduce the threat of takeover, which in turn depreciates share values.

Restrictions on share transfer may substantially depress the market price of shares owned by farmers. It is of interest in this context that the requirement that Air New Zealand 'A' shares can only be held by New Zealanders has resulted in that class of share trading below the unrestricted 'B' shares by a margin of more than 20 percent. A requirement that a particular class of share could only be owned by a relatively small group of people in New Zealand could depress the price of that class of shares to an even greater extent.

Conclusion

In considering competition between cooperatives and corporates, the most important point to keep in mind is that both forms of business organisation are perfectly valid. The choice between cooperatives and corporates should not be a public policy issue. It should be determined by competition in the marketplace in an environment in which tax and regulatory regimes are neutral between types of organisation.

It is likely that cooperatives will continue to have important advantages in some activities. When we look at the agricultural supply cooperatives, however, the benefits that they are alleged to offer in terms of allowing farmer control to be maintained seem to be vastly over-rated. Although benefits may exist in some circumstances, they are likely to be increasingly overshadowed by the benefits that farmers can achieve by exercising their ownership rights in these firms in their role as shareholders. As shareholders, farmers have a strong interest in ensuring that the firms are able to adopt profitable diversification strategies; that access to the capital market is not constrained; that management is accountable; and, if they wish to sell shares, that the price is not depressed by restrictions on who may purchase them.

In the New Zealand environment today, the weaknesses of the cooperative structure are most apparent in the dairy industry. The problem of the price distortions arising from the bundling of raw material and investment returns is most acute in this industry, and cannot be effectively solved in a cooperative structure. The separation of investment and supply, in conjunction with an end to the statutory export monopoly, would allow a contestable market to develop for raw milk, boosting farm-gate prices once cross-subsidies are eliminated. It would also allow dairy companies to access a wider range of investors, lowering the cost of capital to the industry and making company management more contestable. The current proposal to form a single large cooperative is, therefore, a poor solution to the dairy industry's problems.

The extent to which New Zealand farmers decide to make further moves toward the conversion of cooperatives to investor-owned firms in the near future is likely to hinge on their perceptions of the balance between benefits and costs of maintaining organisational structures that are intended to preserve farmer control. Perceptions seem to be most optimistic about the benefits of farmer control where single desk exporting arrangements have hitherto discouraged the entry of investor-owned firms into processing and marketing activities. I believe they are likely to change rapidly when investor-owned firms are able to enter these industries and compete on equal terms with cooperatives.

AIC WORLDWIDE NEW ZEALAND
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ELECTRICITY PRICING: COMPETITION AND REGULATION

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ELECTRICITY PRICING: COMPETITION AND REGULATION

Does regulation encourage greater competition and achieve price reductions for consumers?

Beyond any transitory effects, it is *de*regulation and private ownership, not regulation and government ownership, that encourage healthy competition and sustainable price reductions for consumers.

Experience tells us that the regulation of prices, rates of return, quality, quantity or entry into an industry will create never-ending pressures for more regulation. There are always problems in the form of loopholes and unintended side-effects. To fail to 'address' them would bring the existing regulations into disrepute. Expanding their scope helps grow the regulator's empire and keeps unregulated competitors out. Eventually, the edifice collapses and the direction of policy shifts towards deregulation.

The regulation of prices or rates of return politicises price setting and polarises the relationship between users and suppliers. Whatever the regulated level, it can never be low enough to satisfy users. Users will be rightly suspicious that suppliers' costs are too high and that their protestations to the contrary are self-serving. Conversely, suppliers will always complain that the regulated level is too low to cover costs or to justify investment in new technologies or new capacity.

The regulator has neither the incentive nor the information necessary for deciding with any precision who is right. Regulators need to please whoever controls their budgets. If the politics of the time favours short-term price reductions at the cost of a greater risk of future shortages from inadequate incentives to invest, the regulator's incentive is to err on the side of short-term price reductions. Conversely, if today's politics is dominated by concerns about shortages and blackouts, we should expect the regulator to err on the side of the industry.

In this regulated world, prices that start off being too low sooner or later evolve into prices that are too high because of the entry barriers created by regulations. At the end of the day, the regulator is forced to agree that prices must cover costs in order for the industry to be sustainable. At this point, the regulator has to determine the acceptable level of costs and the incumbent has no incentive to reduce costs further. A cost-plus environment is the result. New Zealand's history of price controls shows that they lead typically to inflated prices for goods and services in the long run.

Lower prices or greater competition are not intrinsically sensible objectives from an economic welfare perspective. The right goal for those who want to see the electricity industry make the greatest possible contribution to community welfare is the promotion of an efficient industry. Efficient prices are usually taken to be prices that track marginal cost. The higher the cost of meeting the next unit of demand, the higher prices should be. It is a major analytical error to make lower prices, rather than economic efficiency, a policy objective. This confusion has bedevilled policy in recent years. Economic efficiency is the sum of consumer *and* producer surplus.

The notion that regulating to increase competition necessarily improves welfare is another fallacy. The optimal level of competition depends on the optimal entry barriers. Economic efficiency requires properly scaled entry barriers, based on the rule of law and the protection of property rights. Potential investors in capital intensive network industries will be deterred by governments that come in after the investment has been made with new rules that make competitors a free gift of part of those investments. We could create plenty of competition for any farmer's cows or trees by giving the whole world the right of access to them for a nominal fee. But such competition is obviously inequitable and inefficient.

The persistence of the notion that regulating for more competition and lower prices in electricity would be a good thing stems, of course, from the view that prices will otherwise be too far in excess of marginal cost. This is the monopoly issue. If attention were properly focused on this issue, we would be asking questions like:

(i) how do we know we have measured marginal cost accurately?;

(ii) why would we assume that *all* companies are profit maximising in the archetypal monopolistic manner when many are owned by central or local government and others may be concerned that profit-maximisation could invite entry, bypass, Commerce Act 1986 litigation, or regulation?;

(iii) should concerns about allocative efficiency dominate considerations of productive and dynamic efficiency?; and

(iv) why should we assume that the proposed regulations represent the best response to any perceived problem?

The real cost of fallacious ideas is that their uncritical acceptance by too many politicians, public servants, journalists and lay people means that these more important questions are not adequately examined.

Is there too little regulation compared with similar countries?

The twentieth century has been the century of big government. The Berlin Wall only fell in 1989, and the idea that this event has lessons for the ambitions of governments in the Organisation for Economic Cooperation and Development (OECD) countries to own and control industries is still not widely shared. There have been many moves towards privatisation and only a few in the opposite direction, but in many countries regulation continues to grow. Yet public ownership of industries is merely the ultimate form of regulation.

In the United States there is widespread disillusionment with rate-of-return regulation. The problems with it led Britain to adopt CPI-X regulation. However, the choice of X, an allowance for efficiency gains, is inevitably political. There seems to be no reason why the same factors that eventually force rate-of-return regulation to create a cost-plus environment will not do the same with a CPI-X regime.

New Zealand's optimised deprival value (ODV) regime puts it well on the way to de facto rate-of-return regulation. This, and continuing central and local government ownership, make heavy-handed regulation a central feature of the New Zealand situation. We are no doubt in good (or plentiful) company in this regard internationally, but there is little comfort in being in this state. Twenty years ago we were in good company in regulating financial markets, but these have now been extensively deregulated worldwide as the costs of regulation became more widely understood.

With a surplus of generation capacity, why are prices so high?

How do we know what the 'right' prices for electricity should be? The more relevant question is surely why most of the industry is still publicly owned. As long as this situation prevails, we should expect prices to reflect some political trade-off between the desire of the government and councils for revenue and the desire to deliver lower prices to voters. Competition, subject to efficiently scaled entry barriers, is the key to forcing prices to track marginal cost. State ownership can easily deter competition. Moreover, the drift to ODV-based rate-of-return regulation is likely to create incentives to inflate ODV values and hence prices.

If prices for generation were tracking marginal cost, their level would depend on the marginal cost of additional capacity and when that capacity might be required. The marginal cost of additional generating capacity would be affected by the costs and difficulties of obtaining resource consents, the possibility of future carbon taxes and the like. The timing and location of the next increment of generating capacity might depend on investment decisions in respect of the national grid.

Over the past decade we have seen enormous swings in the estimates of the long-run marginal cost of generation. The lesson we should draw is that a degree of humility is in order in speculating about trends in marginal cost in a politicised environment.

Costs of regulation versus the status quo

Obviously, adding more layers of regulation to those already in place can be expected to increase the costs of supply. Light-handed regulation should produce the greatest achievable level of productive and dynamic efficiency. Regulations aimed at monopoly pricing are only justifiable, in terms of efficiency, if they produce gains in allocative efficiency that outweigh losses of productive and dynamic efficiency.

One of the notable features of the recent regulatory measures and proposals is the absence of any serious attempt to establish that each and every company being regulated is pricing above marginal cost or breaching the Commerce Act 1986. Official analyses are also explicitly ignoring the option of privatisation.

The New Zealand Business Roundtable (NZBR) took a close interest in the Regulatory Impact Statement on the regulatory proposals in this year's Commerce (Controlled Goods and Services) Bill. Our consultant's analysis found that the document failed to (i) identify the root causes of any problems; (ii) determine a policy objective that did not pre-justify the proposed measures; (iii) identify the required range of feasible options; and (iv) establish that the proposed benefits exceeded the costs, even compared with the status quo. Such documents do a serious disservice to governments and the policy-making process.

The politics of the industry appear to have reached the stage where the assertion of natural monopoly suffices to justify additional regulation. No attempt is being made to consider alternatives to regulation (such as privatisation), to establish the relationship of prices to marginal cost, or to ask whether the current environment is creating cost-plus incentives.

Reducing prices further down the chain

Competition and private ownership with light-handed regulation are the best known devices for achieving the lowest achievable costs and prices in most industries. Under such a regime, prices will track marginal cost, albeit imperfectly. The relationship is not precise and instantaneous, in part because it takes time for competitors to find innovative ways of overcoming entry barriers that allow supernormal profits.

We also know that heavy regulation and government ownership are excellent devices for entrenching privileges (cross-subsidies) and a cost-plus environment. Politically determined prices are likely to fluctuate greatly around cost – as anyone who remembers the Muldoon government's revenue-raising electricity price hikes in the 1970s can attest.

Short-termism is the enemy of sound policies and using regulations to reduce prices in the short term can easily have perverse effects. Sound policy needs a medium-term focus. The naive model of perfect competition with instantaneous market-clearing and prices equal to marginal cost is not a relevant standard for policy making. In real-world markets there are always departures from marginal cost, particularly with innovation. The critical spur to competitive entry is the hope of a supernormal profit. Regulations that remove the hope of supernormal profits remove the spur to enter.

The NZBR does not see any monopoly arguments for the regulation of electricity generation and retailing. Any issue of monopoly arises in respect of the grid and the local lines companies.

The argument that local lines companies will capture all the benefits from efficiency gains in generation is not an argument against achieving such gains. Any such argument is about equity rather than efficiency. Moreover, the proposition that profit-maximising lines companies will capture all the benefits if they are monopolists is not self-evident, even in theory. If it becomes cheaper to expand capacity by investing in energy, rather than expanding line capacity, the marginal cost of a lines business could fall.

The forced separation of lines and energy companies clearly denies the community the benefits of any synergies from common ownership. The argument that separation makes monopoly profits easier to identify is suspect because it runs the risk of confusing economic rents with monopoly profits. Incumbents should earn large rents if marginal cost is well above average cost. Marginal costs depend on future costs, not past costs. Greater disclosure about existing costs may tell us little about future costs at the margin.

I suspect that if the industry were carefully analysed it would become apparent that the opportunities for competition and bypass of lines vary considerably across the system. In addition, it is likely that some of the activities of existing lines companies are more contestable than others. Another relevant factor is the possibility of technologies that could overcome entry barriers if firms could be confident that their introduction would not invite regulation because of the regulatory dynamic mentioned earlier.

I do not know if it is or might become economically feasible for cable television, telephone, water, rail, roading or natural gas companies to lay cables that compete with local lines businesses for electricity. I suspect that the fact that they have not done so this century owes more to government ownership, regulation and control than to 'natural monopoly'. Obviously, the incentive of private investors to devote resources to exploring such possibilities depends on their ability to enter the market and their assessment of the risk that the profits from any such investments might attract regulation. Such multi-utility options are virtually ruled out with government or council ownership of utilities.

Milton Friedman once observed that societies face three uncomfortable choices when intractable monopoly problems exist. One is an unfettered private monopoly. The second is a regulated private monopoly. The third is regulation through government ownership. All options are unpalatable.

However, the problem is reduced if the monopoly problems are largely transitional. In my view the proposition that local lines do not present intractable natural monopoly problems should be taken seriously. Were it not for a century of state monopoly, markets would surely have eroded many natural monopoly attributes in electricity lines companies long ago. In a more competitive environment we could expect lines to be bypassed on a piecemeal basis as the industry evolves.

Clearly issues of transition are relevant. But the challenge is to find ways of achieving a transition that will lead to market-discovered solutions to transitional problems of dominance.

The NZBR has yet to be persuaded that the hoped-for benefits from continuing government ownership and heavier-handed regulation exceed the costs. This is not to argue that the Commerce Act 1986 provides the best of all frameworks for a regime of light-handed regulation. However, many of the recent proposals to amend it also go in the wrong direction.

The way forward

Because efficient prices track current and future costs over time they depend on subjective judgments about future demand, future technologies and future costs.

Such judgments are inherently entrepreneurial. Whose judgments should prevail? In a market the prices that emerge are those that result from a contest between competing entrepreneurial views. The profit motive ensures that attention is directed at exhausting ways of reducing costs and increasing revenue.

In contrast, government ownership dilutes the profit motive and necessitates political interference. Banks may lend to a state-owned enterprise because of its implicit government guarantee, not because of the quality of its decisions. Private sector competitors may hesitate to enter the electricity industry because of the risk that the government will regulate to protect its own interests.

In short, there are powerful reasons for arguing that electricity is simply another private good that should be supplied privately. Any incoming government should privatise as many of its electricity companies as possible and require councils to do likewise.

In terms of regulation, there is no substitute for high quality analysis. The forced separation of lines and energy companies occurred without any demonstration that the benefits from separation and from regulating line charges would exceed the costs. There is a good case for repealing this legislation and allowing mergers, subject to normal Commerce Commission scrutiny.

Much greater attention needs to be paid to the cost-plus biases implicit in the ODV approach, and analysis of any further regulatory proposals should explicitly compare the net benefits of light-handed regulation with the current and proposed heavier-handed approaches.

AUCKLAND REGIONAL CHAMBER OF COMMERCE AND INDUSTRY WORLD TRADE CLUB BREAKFAST

HANDS-ON, HANDS-OFF OR HAND-OUTS?

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HANDS-ON, HANDS-OFF OR HAND-OUTS?

The background to this discussion is, I believe, the widespread view of many of us in the business sector, and others in the community at large, that the New Zealand economy is not doing as well as it should be. That view is based on such things as the zero rate of economic growth last year, the large current account deficit and external debt ratio, and the slippage in many economic indicators over the past 3–4 years.

It is necessary to keep a sense of perspective in assessing the current situation. As Don Brash, the governor of the Reserve Bank, pointed out in a speech last month, growth in gross domestic product (GDP) in the six years from 1992 to 1997 averaged 3 percent per annum, better than in Japan, in continental Europe and in the United Kingdom, and almost identical to the growth in Australia on average over those six years. The most detailed study of recent productivity trends in New Zealand concluded that "to the extent we can make like-with-like comparisons with Australia (another country that has had a sizeable but more gradual reform programme over a similar period) New Zealand's performance (in multi-factor productivity) appears to be at least comparable". And official forecasts suggest that growth in New Zealand over the next two years will average around 3 percent, closely similar to that projected for Australia. So, as Dr Brash observed, it is hard to see strong grounds for pessimism here.

But the grounds for dissatisfaction with New Zealand's current performance are nevertheless real. Despite its recent economic strength, Australia is no stand-out benchmark for New Zealand, both countries are falling well short of their potential, and New Zealand has lost much ground in terms of international competitiveness and attractiveness for investment. Those people who have been pointing to the outflow of talented people and New Zealand firms relocating to Australia should recall that in the mid-1990s most of the traffic was in the opposite direction. New Zealand was benefiting from the consistent economic framework that had been put in place in earlier years and by a momentum of reform that had outstripped Australia and other countries. The gains were tangible and New Zealand was attracting attention in Australia and elsewhere for the quality of its economic policies.

What has happened in the intervening period? The answer, unhappily, is that New Zealand has gone backwards in many respects while Australia and other countries have moved ahead. We have seen a massive increase in government spending, extensive re-regulation of the economy and only stop/start progress in many areas of microeconomic reform that are crying out for attention. Meanwhile Australia has followed New Zealand's earlier success in achieving a low inflation environment, a budget surplus, large-scale privatisation at both state and federal levels, progress towards a better tax system and a deregulated labour market, and much more.

Simple logic suggests that if New Zealand wants to recover the levels of competitiveness and economic vigour of a few years ago, we ought to return to the path we were on and make up for lost time. I shall return to that thesis later. But recently, as is usually the case when the economy is struggling, there have been calls for a more interventionist, so-called 'hands-on' approach, to managing the economy. Instead of, or as well as, following previous policies we are being urged in some quarters to support more activist approaches which for convenience might be labelled industry policies. The usual candidates put forward include investment and export tax incentives, subsidies for high-tech industries and government support for things like venture capital, export credit insurance and research and development (R & D).

How should we react to such proposals? I think we should give them a fair hearing and not simply dismiss them as Muldoonism. Few people after all are proposing a return to tariffs; the focus is on budgetary assistance and at levels much lower than those in the past.

I suspect most proponents of these ideas are well intentioned and not motivated simply by the prospect of handouts, and many of the policies are superficially plausible. If they stand up to scrutiny, why would anyone not want to support them?

How does one evaluate proposals for business incentives? Clearly they benefit firms that qualify for them, at least in the short term. That is the easy and visible part of the analysis. But there is no free lunch with most government interventions: they come at a cost. What happens in the economy as a whole when governments directly assist particular businesses? Let us consider some of the consequences.

The first thing that happens when a firm or industry is assisted is that it becomes more profitable and expands, which is the intention of the policy. However, it does so by drawing capital, skilled labour and other resources away from other industries. Those industries have to pay more to retain resources, they are less profitable as a result, and their growth is curtailed. That is why people rightly point out that picking winners invariably means picking losers – some firms or industries are inevitably disadvantaged by the policy.

What happens to the pattern of resource use in the economy? The answer is that at the margin scarce resources are drawn into industries that are only profitable because of the assistance, and away from industries that can stand on their own feet. We invest more in industries that are less competitive. The result is that from a national point of view resources are misallocated into less socially valuable activities and potential national income is lost.

Few people today think that politicians and bureaucrats can do a better job of picking successful ventures than business people risking their own money or that of their shareholders. But, much as they sometimes try to deny it, proponents of industry policies are always engaged in picking winners in the sense of encouraging some industries at the expense of others. Some industries would gain more from investment incentives because they make more intensive use of fixed assets; some industries will gain more from R & D incentives because they undertake more R & D; and some industries are more export oriented than others and would benefit more from export assistance than import substituting industries that save foreign exchange. The only way you can assist all industries neutrally is to subsidise them at the same rates on the basis of the value added in production. But if you assist all industries in a way that does not distort the use of resources in an economy you end up in the same position as if you had not intervened at all, except with a much higher tax burden.

Another consequence of budgetary assistance, whether in the form of grants or tax incentives, is that tax rates have to rise relative to what they would otherwise be. With two out of every five dollars of national income being spent by governments at all levels, New Zealand is already a highly taxed country. Taxes are expensive to raise, not just because of the administration and compliance costs involved but because they distort incentives to work, save, invest and take risks, and thereby reduce potential national income. Raising an additional dollar of tax revenue may well cost around 30 cents in lost national income. What that means is that an investment project with a one-year payback supported by a tax-funded subsidy has to yield a 30 percent return on top of a normal pre-tax return of, say, 10 percent if it is to benefit the economy. The required hurdle rate falls for projects with longer payback periods but remains high. The government would need to be exceptionally good at picking winners to pass that test.

Specific business programmes have additional problems. Tax incentives have a habit of turning into tax loopholes, as we saw with things like films and bloodstock. Does New Zealand business want another Winebox scenario? Accelerated depreciation allowances encourage capital intensive projects, which would be an odd bias with unemployment standing at 7 percent of the labour force. By taking on risks that no commercial financial institution would accept, government-run venture capital or economic development funds like the Development Finance Corporation (DFC) have a long track record of requiring taxpayer bail-outs. Export credit assistance encourages businesses to deal with countries or counterparties that they would shun if they faced normal commercial insurance rates. The government has just written off a $14 million debt incurred by the Dairy Board in Peru. Why should taxpayers be asked to bear the risks of firms doing business in, say, Russia or Indonesia?

There are other downsides associated with industry policies. They are inevitably bureaucratic and cost a lot to administer. They encourage business people to spend time lobbying rather than improving their businesses. They divert politicians' attention away from the need for more fundamental reforms. Taken very far, they breed a culture of political favouritism or worse, as we saw in Asia and indeed in New Zealand in earlier years.

But if specific business incentives have little going for them from a domestic perspective, should New Zealand nevertheless offer them because other countries do? This is a variant of Bill Sutch's argument for import protection on the grounds that New Zealand could not remain an "island in a sea of controls". We learned to our cost the fallacy of this argument and the analysis is no different for other incentives.

When you think about it, this response is as illogical as that of a person deciding to take up smoking cigarettes because they are worried that their health is being affected by passive smoking. When foreign governments subsidise their industries, they damage the health of their economies for the reasons we have already seen, and they also damage us by polluting the international trading environment. Through diplomacy and negotiations we should try to persuade them to desist, but we do ourselves no favours by adding self-inflicted damage to the effects of the bad policies of other governments. The argument is the same as for trade barriers and has nothing to do with leading the rest of the world; as US Federal Reserve chairman Alan Greenspan recently put it:

> . . . if trade barriers are lowered by both parties, each clearly benefits, but if one lowers barriers and the other does not, the country that lowered barriers unilaterally would still be better off having done so.

People rightly point out that some New Zealand firms may shift to, say, Australia because of tax holidays, subsidised land or other investment incentives. But other Australian industries are bearing the cost of such policies and as a result attract less investment, both domestic and international. There is no free lunch in an international context either. There would be the same consequences for New Zealand if we matched such incentives. Research studies going back many years conclude typically that such incentives distort an economy's investment pattern but do little to boost investment overall. Most of us in business are also conscious that what governments give, governments can take away. The evidence suggests that much more fundamental factors drive investment flows, starting with political stability, low tax rates, good infrastructure, the availability of skilled labour and the quality of a country's overall policy environment. The Australian Industry Commission (now Productivity Commission) has reported that:

> A succession of surveys of senior business people has revealed that, for them, industry policy has much more to do with the basics of good economic governance than with selective inducements.

The Commission has also pointed out that:

> . . . to attract projects which will deliver net benefits to Australia requires a capability to overcome the inherent difficulties in identifying the presence of external benefits and quantifying them. This is a difficult enough task after an investment has been made, let alone in advance.

The Australian government rejected many of the proposals of the Goldsworthy report that advocated special incentives to attract information technology industries and the Mortimer inquiry recommendations for investment incentives. Currently there is pressure in Australia to scrap or reduce accelerated depreciation in exchange for a lower company tax rate. Budgetary assistance in Australia has not been growing and therefore cannot account for the relative turnaround of Australia and New Zealand as investment locations. Nevertheless, New Zealand should be complaining, perhaps more vigorously, about aspects of it that distort the closer economic relations (CER) trading environment.

We should be wary of the pitfalls of casual observation in this area. Some people note that some countries that have performed well at times provide various business incentives and conclude that they must be the cause of their good performance. They overlook the fact that many countries have recorded a dismal economic performance despite having a raft of incentives – pre-1984 New Zealand being a classic case in point. The countries they cite as examples of successful interventionism seem to change every few years. Japan was the model a few years ago before its economy went into decline. Ireland is now held up as a model of successful interventionism. But I have yet to read a study on Ireland that attributes its success in the past 10 years to its selective industry policies, as opposed to the policies of fiscal and monetary discipline, low taxes on investment and general economic liberalisation that Irish governments have put in place. To the contrary, the latest Organisation for Economic Cooperation and Development (OECD) report on the Irish economy states that:

> . . . the long history of activist industrial and tax policies has left Ireland with a possibly distorted industrial structure.

It goes on to say that:

> . . . the area that is possibly the most clearly in need of a shift in direction is that of industrial policy, at least as it concerns foreign investments. . . . The justification for the selective project approach in terms of systemic market failures
> is elusive.

Similarly, no commentator that I am aware of suggests that Australia's recent good performance is due to interventionist industry policies as opposed to 15 years of fundamental economic reforms.

As the OECD statement suggests, sound economic analysis requires government interventions in industry to be based on proper evidence of market failures arising from problems of public goods or externalities. These concepts should be interpreted with care, but there is a reasonable case for government involvement in such things as basic or 'public good' scientific research that may generate benefits for the community beyond those accruing to firms. In the absence of such sources of market failure, however, decisions about investments and risks are best left to the private sector to make.

Contrary to some media commentary, the debate over industry policy cannot sensibly be construed as a debate between a 'hands-off' and 'hands-on' approach to managing the economy. With 40 percent of national income being channelled through the public sector, it is hard to argue that current policies are 'hands-off'. No one suggests that the government does not have a major role in creating the conditions for the business sector to prosper. We need governments to provide a sound set of rules in which firms and markets can operate, protect property rights, promote competition and supply a range of public goods. Governments can also play a role in promoting foreign investment and immigration. On the other hand, governments should not be engaged in steering and directing industry, and doing things that are the role of the private sector. In other words, both 'hands-on' and 'hands-off' stances are needed where appropriate; what we do not need are handouts.

To encourage the entrepreneurship and wealth creation that New Zealand badly needs, I suggest that the prime task facing New Zealand governments is to reduce the barriers facing its entrepreneurs. That means an all-out assault on the regulatory and compliance burdens that have been inflicted on businesses in recent years, and on the tax burdens arising from inflated levels of government spending. In short, smaller government and lower taxes. Ireland has reduced government spending from over 50 percent of GDP in the 1980s to around 32 percent today – the largest reduction in the OECD and a major factor in its economic success. I sense there is solid support within the business sector for priority to be given to reducing tax and regulatory burdens. The New Zealand Manufacturers Federation has recently stated that it "considers a significant cut in business tax would be more effective and cause less distortions than tax measures targeted at specific areas such as R & D which could influence business choices for tax rather than value-adding reasons". The New Zealand Business Roundtable and the Auckland and Wellington Chambers of Commerce outlined a strategy for growth entitled *Moving into the Fast Lane* in 1996 and I believe it remains as valid today as it was then.

When all is said and done, it is surely self-evident that spending an additional $100 million or any comparable amount on so-called business assistance is hardly going to register in a $100 billion economy. Suppose, to be heroic, there is a 50 percent rate of return on our $100 million. Once the deadweight costs of raising the additional tax have been deducted, you are left with, say, an extra $20 million of national income. That simply does not bear comparison with the gains from initiatives such as deregulating the accident insurance market, removing the producer board monopolies, undoing the damage attributable to the Employment Court, and lowering company and personal taxes. In reality, for the reasons I have given, I believe a return to selective industry interventions, even if on a smaller scale than Muldoonism, would yield negative rather than positive returns. When the coalition government proposed giving $100 million of so-called assistance to business, the polite answer was "thanks but no thanks – we prefer tax reductions instead". That, in my view, was the right answer at the time and I believe it remains the right answer today.

EDUCATION AND THE LABOUR MARKET

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE 2000 REVIEW OF THE MINIMUM WAGE

OCTOBER 2000

THE 2000 REVIEW OF THE MINIMUM WAGE

1 Introduction

1.1 This submission on the annual review of the minimum wage is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily chief executives of major New Zealand business firms. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall national interests.

1.2 The Minimum Wage Act 1983 (the Act) states that the governor-general may prescribe by order in council minimum rates of wages payable to any class or classes of workers. The class or classes of workers are to be defined by reference to their ages. It is not mandatory to prescribe such wage rates. The minister of labour is required to review any minimum wage rates prescribed under the Act before 31 December of each year but is not required to recommend that such rates be adjusted. The Act is silent on both the objectives of minimum wages and the criteria that are to be applied in setting or reviewing minimum wages. The Act does not apply to apprentices, certain classes of people engaged in training and inmates of charitable institutions.

1.3 The balance of this submission is presented in four sections. The next section (section 2) provides background information on minimum wages and reviews key employment trends. Section 3 examines the objectives of statutory minimum wages. The economic effects of minimum wages are discussed in section 4. Our conclusions and recommendations on the review are presented in section 5.

2 Background

2.1 The 2000 review takes place in the context of continuing high unemployment particularly among the young, those with few skills, and Maori and Pacific Island peoples. According to the Household Labour Force Survey, 18.1 percent of people aged 15–19 years and 9.3 percent of those aged 20–24 years were unemployed in the June quarter of 2000 compared with 6.1 percent for all age and ethnic groups. Thirteen percent of Maori and 10.8 percent of Pacific Island peoples are reported to be unemployed. They are disproportionately represented among the young unemployed. Such unemployment should be of the utmost concern to the government and the prime consideration in the 2000 annual review.

2.2 Statutory minimum wages have been prescribed for people aged over 16 years and under 20 years of age (youth) and for adults (aged 20 years and over). The present minimum weekly wages of $182 for youth and $302 for adults have applied since 1 March 2000.[1] Those wages were 8.3 percent and 7.9 percent higher than the minimum youth and adult wages respectively that applied in February 2000.

2.3 As could be expected in these circumstances, labour market outcomes for youth and young adults, the groups most affected by minimum wages, are inferior to those for the population as a whole.

2.4 The unemployment rate among 15–19-year-olds remained at 18.1 percent between the March quarter of 1999 and the June quarter of 2000 whereas the unemployment rate for the population as a whole has decreased from 7.5 percent to 6.1 percent. Although this is a comparison between the period before the increase and the latest

[1] These rates reflect a 40-hour week. Equivalent rates are prescribed where workers are paid on an hourly or daily basis, or work for more than 40 hours in a week.

period for which statistics are available, it may be affected by seasonal factors. However, on a June quarter to June quarter basis, the labour market outcome for youth is even more adverse. On this basis the unemployment rate for 15–19-year-olds increased by 1 percentage point while the overall unemployment rate fell by 0.9 percentage points.

2.5 The unemployment rate for 20–24-year-olds has fallen from 13.1 in the March quarter of 1999 to 9.3 percent in the June quarter of 2000. A smaller reduction occurred on a June quarter of 1999 to June quarter of 2000 basis. However, there has been an equally pronounced decline in labour market participation by the 20–24 age group. Between the March quarter of 1999, and the June quarter of 2000, labour market participation fell substantially from 78.3 percent to 70.2 percent. This may well indicate that young adults are being discouraged from looking for employment. Such an outcome is consistent with a rise in the adult minimum wage.

2.6 The labour market outcomes for youth and young adults should also be examined in the broader context of recent changes in minimum wages and medium-term trends in employment. The increase in minimum wages approved in the 1999 review followed a massive 10 percent increase that was implemented on 1 March 1997. Reviews conducted in 1997 and 1998 left the level of minimum wages unchanged. Even so, minimum adult and youth wages in March 2001 are expected to be between 9 and 15 percent higher in real terms on both a before- and an after-tax basis than they were in 1996. Not surprisingly, labour market outcomes for youth and young adults since then have been substantially worse than for the labour force generally (see table below).

2.7 The number of 15–19-year-olds and 20–24-year-olds in employment has fallen by a substantial 7 and 17 percent respectively since June 1996 whereas total employment has increased by 4 percent. The level of unemployment has increased by 18 percent for 15–19-year-olds compared with 8 percent for the population in general. In contrast, the level of unemployment of 20–24-year-olds has declined by 4 percent. More significantly, the labour force participation rates for youth and young adults have declined by 3 and 7 percentage points respectively compared with a decline of 1 percentage point for the population as a whole. The unemployment rate for youth and young adults has increased relative to that of the population as a whole.

Labour market performance for youth and young adults
June quarter 1996 to June quarter 2000

	June quarter 2000	June quarter 1996	Change	
Employment	000s	000s	000s	Percent
15–19-year-olds	115.8	124.7	-8.9	-7.1
20–24-year-olds	161.7	193.9	-32.3	-16.6
All age groups	1,753.2	1,683.5	69.7	4.1
Unemployment				
15–19-year-olds	25.7	21.8	3.9	17.9
20–24-year-olds	16.6	17.3	-0.7	-4.0
All age groups	114.3	105.9	8.4	7.9
Unemployment rate	Percent	Percent	Percentage Points	
15–19-year-olds	18.1	14.9	3.2	
20–24-year-olds	9.3	8.2	1.1	
All age groups	6.1	5.9	0.2	
Participation rate	Percent	Percent	Percentage Points	
15–19-year-olds	51.9	55.3	-3.4	
20–24-year-olds	70.2	77.4	-7.2	
All age groups	64.6	65.6	-1.0	

Source: Statistics New Zealand (2000), Household Labour Force Survey, Statistics New Zealand, Wellington.

2.8 While factors other than the change in minimum wages will have contributed to these outcomes, minimum wages can be expected to have played an important part. Although the government predicted modest economic growth through to 2003/04 in the budget, little improvement in the rate of unemployment is projected. The overall rate of unemployment is forecast to be 5.7 percent in the March quarter of 2001 and 5.6 percent in the March quarter of 2004. These forecasts are likely to prove optimistic given the massive deterioration in the quality of economic policy over the past few years and the consequent slump in business and consumer confidence.

3 Objectives of statutory minimum wages

3.1 The Department of Labour reported in 1999 that there are two commonly cited objectives for a minimum wage:

a income redistribution, reflecting the view that, without intervention by a minimum wage, the income of a person or household may be insufficient; and

b the protection of vulnerable employees, reflecting the view that a minimum wage ensures that employers are not able to exercise a disproportionate influence over wages in a particular industry or location when workers lack the necessary information and skills to bargain effectively.[2]

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[2] MacPherson, Elizabeth (1999), "Minimum Wage Review 1999", unpublished report to the Minister for Enterprise and Commerce, 25 November, Department of Labour, Wellington, p 7.

These objects are reflected in the minister of labour's request for submissions that states that:

> The minimum wage rates that are set attempt to make work pay, and to protect vulnerable workers, while at the same time being set at a level that businesses can afford.[3]

3.2 Statutory minimum wages are an inappropriate instrument for achieving these equity objectives. As noted by the Department of Labour, they are "poorly targeted" and are "unlikely to reach many of those who may need assistance".[4] The Department concluded that "an increase in the minimum wage is not an effective means of targeting income assistance".[5] Most people on low wages are in households on middle to upper incomes with income deciles 4 to 7 inclusive accounting for 56 percent of all minimum wage workers.[6] A low wage is often a second or subsequent market income of a household. Moreover, many people on low wages also receive other government assistance. Tenants in state houses, for instance, will receive higher housing subsidies following the reintroduction of income-related rents.

3.3 Professor Lawrence Mead, drawing on research conducted in the United States, observes that the great majority of poor workers are mainly poor because of their low hours of work. In his view "Poverty . . . has little connection to low wages in general" because "few steady workers at any wage are poor".[7] Moreover, income is often a poor measure of individual welfare. For that reason, poverty studies usually focus on household consumption that tends to be less closely related to income at the bottom end of the income distribution than elsewhere.

3.4 Welfare and tax systems are better instruments than minimum wages for addressing valid income distribution concerns. The level of benefits reflects society's assessment of the minimum acceptable income that should be available to residents. Over recent years governments have taken some helpful steps to encourage beneficiaries of working age to engage in employment where feasible. A minimum wage in excess of the community wage is inconsistent with such policies and an increase in minimum wages would be a step in the wrong direction. It makes no sense, for example, to deny a person a job at a wage that would provide a higher income than the community wage.

3.5 The proposition that minimum wages are an effective means of protecting vulnerable employees is also mistaken. It reflects an outmoded view that employees are powerless in bargaining with employers. As Alchian and Allen observed in relation to collective bargaining:

> . . . employers compete against other employers, and employees against other employees – not employees against employers, as folklore says. It is the availability of higher-valued alternatives . . . that increases bargaining power.[8]

The best protections that workers have are the ability to change jobs and the normal legal sanctions that apply in the event of offences such as fraud or civil disputes.

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3 Wilson, Margaret (2000), Annual Review of the Minimum Wage, personal correspondence, 8 September.

4 MacPherson (1999), *op cit*, p 2.

5 MacPherson, *ibid* p 12.

6 MacPherson, *ibid* p 8.

7 Mead, Lawrence, 'Raising Work Levels Among the Poor', *Social Policy Journal of New Zealand*, Issue eight, March 1997, pp 1–28, p 7. Note that minimum wages in the United States are generally set at a lower proportion of mean wages than in New Zealand.

8 Alchian, Armen and Allen, William R (1983), *Exchange & Production: Competition, Coordination & Control*, Wadsworth Publishing Company, Belmont, p 328.

The objective of protecting vulnerable workers makes no sense at all in the majority of centres where there is a wide choice of employers. Furthermore, employees who are unhappy with their pay and conditions in a locality with few employers may be able to move to another town or city. It is not necessary for all, or even most, employees to transfer as it is decisions at the margin that affect wages and conditions. Employees who choose to remain can free ride on the actions taken by those employees who are prepared to act.

3.6 If government action is justified on information grounds, the government should arrange for information to be made available to affected employees. Those grounds do not justify statutory minimum wages.

3.7 The government promoted the Employment Relations Act 2000 (ERA) on the mistaken grounds that it was required to protect vulnerable workers. However, if the government is confident that the ERA will achieve this objective, the minimum wages legislation is redundant. Its retention would indicate the government's limited confidence in the efficacy of the ERA.

4 Employment and other effects of statutory minimum wages

4.1 A conventional economic analysis and the weight of empirical evidence show that binding statutory minimum wages result in lower levels of employment than would otherwise be experienced in an economy. The grounds for this view and recent challenges to it were reviewed in detail in the Business Roundtable's previous submissions and in a 1994 report prepared by ACIL, and are summarised below.[9]

4.2 As is well known, orthodox economic theory predicts that an increase in the statutory minimum wage above the market-determined minimum wage will reduce the numbers employed and the aggregate hours of employment. Those people who retain their jobs, and were previously employed at a wage below the new minimum, gain a pay increase. However, the market incomes of those who lose their jobs fall dramatically to zero. The main claim of those who oppose rises in minimum wages (and, indeed favour their abolition) is that the losses imposed on the latter outweigh the benefits accruing to the former and that overall economic efficiency and national income are reduced through disemployment and other effects.

4.3 An increase in the minimum wage tends to increase the costs of goods and services that are produced by unskilled labour. The producers of unskilled-labour-intensive traded goods and services (eg shoes and clothing) are unable to put up their prices. The production of such goods and services therefore tends to decline because they are less profitable to produce. Imported products would tend to increase. Both effects can be expected to reduce the quantity of unskilled labour that is employed. In the case of non-traded goods and services that are unskilled-labour-intensive (eg fast food products) producers tend to raise their prices relative to the prices of other goods, thereby reducing the quantities consumed and the quantity of

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9 New Zealand Business Roundtable (1996), 'Review of the Statutory Minimum Wage', unpublished submission, New Zealand Business Roundtable, Wellington; Sloan, Judith (1997), 'Annual Review of the Minimum Wage', unpublished submission, New Zealand Business Roundtable, Wellington; New Zealand Business Roundtable (1998), 'Submission on the 1998 Review of the Statutory Minimum Wage', unpublished submission, New Zealand Business Roundtable, Wellington; New Zealand Business Roundtable (1999), 'Submission on the 1999 Review of the Minimum Wage', unpublished submission, New Zealand Business Roundtable, Wellington; and ACIL Economics and Policy Pty Ltd (1994), *What Future for New Zealand's Minimum Wage Law?*, New Zealand Business Roundtable, Wellington. Copies of these submissions and the ACIL report are available on request.

unskilled labour hired to produce such goods. Moreover, the producers of traded and non-traded goods tend to substitute other inputs for unskilled labour in their production processes.

4.4 On the basis of recent statistical studies, some researchers have suggested that the effect on employment of statutory minimum wages may be close to zero or even positive.[10] One argument for this view is that, within a certain range, a minimum wage will induce a monopsonist to increase the quantity of a given type of labour that is hired.[11] While this proposition rests on conventional theory, genuine monopsony is rare and is not a sound basis for expecting an increase in the minimum wage to raise employment. A further argument is that the 'shock' of an increase in the minimum wage induces employers to find ways of improving labour productivity to an extent that enables them to profit by increasing the quantities of labour hired. This is essentially an ad hoc explanation that is, at best, barely plausible. It is tantamount to assuming that previously employers persistently failed to perceive and exploit opportunities to increase profits.

4.5 The theoretical underpinnings of these views are both contrived and unconvincing and there are serious methodological problems with the Card and Krueger study that propounded them. This contrasts with the commonsense propositions that underlie the conventional view. Similar findings to these conclusions are found in the literature.[12] Furthermore, 87 percent of labour economists in the United States who participated in a random survey agreed that the existence of a minimum wage increases unemployment among young and unskilled workers.[13] Consistent with this conventional view, officials concluded that:

> . . . the minimum wage has some negative impact upon employment, leads to increased unemployment, results in reduced skill formation, may have a slight [upward] impact on inflation and has a variety of fiscal consequences.[14]

4.6 The conventional view, based on empirical studies over many decades (predominantly from the United States), is that a 10 percent increase in the minimum wage can be expected to reduce employment of low-wage workers by something in the order of 1 to 3 percent.[15] On this basis a 'ballpark' estimate is that the number of youths and young adults employed could decline by perhaps 550 to 1650, depending on the number of people in these groups with jobs at the bottom of the wage spectrum, if minimum wages were increased by, say, 2 percent. Additional job losses could also be expected in other adult age groups.

4.7 The adverse effects of higher minimum wages extend beyond job losses. When the price of labour is artificially increased by statute, employers tend to adjust non-price attributes of the job in an attempt to retain their lower-skilled staff. In net

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10 Card, David E and Krueger, Alan B (1995), *Myth and Measurement: The New Economics of the Minimum Wage*, Princeton University Press, Princeton and Chapple, Simon (1997), 'Do Minimum Wages Have an Adverse Impact on Employment? Evidence from New Zealand', *Labour Market Bulletin*, No 2, pp 25–50.

11 A monopsonist is defined as the sole hirer of a given class of labour in a given market. An example might be a country hospital that hires nurses living in the surrounding area.

12 Hamermesh, Daniel S, 'Comment', *Industrial and Labour Relations Review*, Vol 48, No 4, 1995, pp 835–838; and Lewis, Philip, 'The Economics of the Minimum Wage', *Australian Economic Review*, Vol 30, No 2, 1997, pp 4–7. Also, see references contained in Sloan (1997).

13 Whaples, Robert, 'Is There Consensus Among American Labour Economists? Survey Results on 40 Propositions', *Journal of Labor Research*, Vol 17, No 4, 1996, pp 725–734.

14 Compton, Jan (1997), 'Officials Paper: Minimum Wage Review 1997', unpublished report to the Minister of Labour, 2 December , Department of Labour, Wellington, p 3.

15 The relevant research is summarised in Sloan (1997) and New Zealand Business Roundtable (1998).

terms even employees who are retained may end up worse off. On-the-job training is often cut back and other job attributes, relating to factors such as management supervision, the pace of work, safety, hours of work, recreation facilities and health and retirement benefits may become less favourable to employees. Fringe benefits including, where relevant, holiday pay, sick leave, health insurance, subsidised food and accommodation, time off for study, year-end bonuses and commission payments tend to become more difficult to obtain or maintain. Furthermore, bargaining agents will seek to preserve or restore non-wage conditions that are eroded by increases in minimum wages.

4.8 While an increase in statutory wages would increase the incomes of people who currently earn an income below the minimum wage and who retain their jobs, those benefits do not, in our opinion, outweigh the adverse consequences for those who would be precluded from employment. If the incomes of low-wage employees are judged to be inadequate, the appropriate remedy is to provide some form of income transfer that does not create undue obstacles to welfare-enhancing employment contracts through the labour market.

5 Concluding comment

5.1 The inescapable conclusion is that binding statutory minimum wages destroy jobs and are a poor policy instrument for advancing equity objectives. For this reason, the Business Roundtable submits that a fundamental review of the minimum wage legislation should be undertaken with a view to its abolition. This approach is consistent with the government's policy of 'closing the gaps' because paid work is the key means by which most people can earn an income and advance up the income ladder.

5.2 Pending a review of the Minimum Wage Act 1983, the Business Roundtable is opposed to any increase in statutory minimum wages; rather they should be reduced, desirably to the level of the community wage with income support providing the safety net. There is no logical reason for denying people an opportunity to work for a higher income than that provided by the government if they are unemployed and dependent on the community wage. Higher minimum wages would reduce the number of jobs available and deny people the opportunity to take up employment that would be attractive to them. A disproportionate number of such people are likely to have no formal educational qualifications, few workplace skills and low productivity. The combined effects of forgone income and training opportunities and lower self-esteem may have serious consequences for already disadvantaged people over their entire working lives.

5.3 Greater opportunity should be provided for people to opt out of the provisions of the Minimum Wage Act 1983 whether or not minimum wages are raised. Exemptions should be provided for all jobs that contain a training component, new entrants to the labour market, people unemployed continuously for more than six months and people who have been convicted of serious criminal offences. It may be possible to implement such a strategy by encouraging affected people to apply for exemption permits that may be issued under the Minimum Wage Act 1983, although a less burdensome approach is clearly preferable.

THE EDUCATION FORUM

SUBMISSION ON THE EDUCATION AMENDMENT BILL 2000

MAY 2000

EDUCATION AMENDMENT BILL 2000

1.0 Introduction

1.1 This submission is made by the Education Forum, an independent group of people involved in education and in business organisations, formed to contribute to education policy through research and debate. Its statement of principles is provided at Appendix A and its current membership at Appendix B.

Amendments affecting schools

1.2 This submission first considers the provisions of the Education Amendment Bill 2000 (the Bill) that directly affects state schools, namely:

- the abolition of bulk funding (or the 'fully funded option') for the payment of school teachers' salaries;
- changes to school governance; and
- the 'tightening' of school enrolment schemes.

The abolition of the bulk funding of teacher salaries is by far the most important change and one for which no rational explanation is provided. We consider it to be a seriously retrograde step. The changes to enrolment provisions are also retrograde. We oppose both sets of changes. The proposed changes to school governance are generally supported but do not, in our view, go far enough. It is curious that changes to improve governance are being proposed while at the same time a school's ability to deploy its resources and to select pupils is being diminished.

1.3 It is also curious that no claim is being made that the bulk funding and enrolment changes will lead to more effective schooling. We consider effectiveness should be a very important consideration in the interests of all school children and that, if this were adopted as a general approach, very different policy prescriptions from those in the Bill would result. We therefore conclude the discussion of these schooling issues with a brief review of the literature on school effectiveness and on the related issues of choice and competition.

Amendments affecting tertiary institutions

1.4 The proposed amendments would, *inter alia*, change the way in which tertiary student associations may move between compulsory and voluntary membership, and how student association fees are collected. Our main concern is the continued statutory provision for compulsory membership of associations in state-owned institutions that enjoy a virtual monopoly status. We consider that requiring compulsory membership is oppressive and infringes individual liberty. Possible justifications for such provisions are examined and found wanting.

Compliance with the Human Rights Act 1993

1.5 The proposed amendments end exemptions for various age restrictions in education legislation and raise very different issues from those in the rest of the Bill. The Bill's Explanatory Note gives no reasons for their removal other than the need for compliance with the Human Rights Act 1993. In the absence of information about the merits or otherwise of retaining the age restrictions we are unable to come to a view about them. We would, however, be concerned if there is an inference that any age restriction is discriminatory as, in our view, there can be no simplistic equation of age restriction with discrimination. Our preference would be to retain the exemptions pending a more detailed review of their merits and, preferably, of the Human Rights Act 1993 itself.

1.6 Our recommendations are summarised at section 8.

2.0 Bulk funding

2.1 The Bill removes from state schools the bulk funding method of paying teachers' salaries (also known as the 'fully funded option'). Bulk funded schools receive their funding direct from the Ministry of Education and are free to spend it according to priorities determined at the school level. Essentially, the funding of the salaries of teachers in bulk funded schools is administered along the same lines as the government funding of other parts of the education system. Preschools, private schools, and tertiary providers are funded by formulae-driven government grants, as are the operational expenses of state schools.

2.2 The bulk funding of teacher salaries was a key component of the *Tomorrow's Schools* reforms of the previous Labour government, though its introduction was long delayed because of teacher union opposition. These reforms were designed to address various problems identified by the 'Picot' taskforce including over-centralisation of decision making, too many layers of administration and insufficient sensitivity to Maori and other minorities. Bulk funding was introduced on a voluntary basis and, with the incentive of additional funding, 837 of the 2700 state schools opted for it, in many cases after "thorough, careful consultation and research",[1] and are now bulk funded.

2.3 Under central resourcing, schools comply with staffing orders that prescribe the number of teachers each school can employ and the number of management units it can use. If a school does not employ the staff or use the units it does not get the resource. Bulk funded schools are exempt from these orders except to the extent that they have to employ a principal and enough teachers to deliver the curriculum. They receive funds, not staffing and management entitlements, and have wide discretion about the use of those funds. They can, for example, flatten their management structure and give greater attention to programmes for children with learning or behavioural difficulties.[2]

2.4 Under the Bill's provisions, bulk funded schools will become centrally resourced during 2001. They overturn, without consultation, formal, written agreements between the minister of education and the 837 schools. The boards of the bulk funded schools decided in favour of this form of funding in the best interests of the children at their schools and are in the best position to decide on such a matter.

2.5 There is no evidence that this method of funding has failed. The recent Education Review Office (ERO) report (1999) "found that the Fully Funded Option has given boards of trustees opportunities to manage their resources more flexibly and to make decisions in a flexible environment . . . [Bulk funded] schools generally have applied the extra funding in diverse and innovative ways, for example to provide additional staff in order to introduce a wider range of programmes, for curriculum resources, or for property initiatives". In seems that bulk funding has done what it was expected to achieve, that is to provide flexibility in the deployment of resources in order to improve teaching and learning. It has not solved problems of poor financial management, and could hardly be expected to have done so. In some cases board/staff relationships suffered, though "there is evidence that boards had made efforts to accommodate staff concerns and over time, working

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1 Education Review Office (1999), *Good Practice in Managing the Fully Funded Option*, Education Review Office, Wellington, October.

2 A decile 6 Auckland primary school reports that bulk funding has freed up teaching staff from various auxiliary duties and thereby enabled them to concentrate on literacy. The percentage of Maori and Pacific Island children reading below their actual age fell from 81 percent in 1996 to zero in 1999. Other similar examples could be given.

relationships had improved" (ERO, 1999, p 23). It can reasonably be assumed that students' learning benefited because "most boards have seen fit to direct their efforts towards professional staffing to support students' learning" (ERO, 1999, p 24), though this would need very detailed achievement data to establish.

No rational explanations have been given for abolishing bulk funding

2.6 No rational explanations are being advanced by the government for the abolition of this method of funding. No reasons are given to explain why funding for state school teaching staff should be treated differently from the funding of the rest of the education sector (2.1). Nor is there any discussion about how the problems that led to, *inter alia*, bulk funding in the first place (2.2) will be avoided now that bulk funding is to be abolished. The reasons for abolishing bulk funding given in the Bill's Explanatory Note are "that the extra funding paid to bulk funded schools would be better used for all schools" and that a result of abolition will be "that all schools . . . [will] have some of the flexibility in funds that only bulk funded schools have enjoyed". The second statement seems to be the reverse of what is intended: bulk funded schools are to lose the flexibility afforded by bulk funding even though flexibility is clearly seen as desirable. It may be that the government has other proposals in mind so that staffing entitlements can be treated flexibly in some way, but this is not apparent from the Bill. It is hard to see how central resourcing can deliver anything like the degree of flexibility available under bulk funding (2.3).

2.7 The Explanatory Note appears to confuse two different things: the *amount* of funding and the *method of delivery*. Bulk funding is a method of funding and has nothing directly to do with the *amount* of funding made available. Moves to increase funding or to achieve more equal funding between schools could be made without abolishing bulk funding. But bulk funding can certainly assist in achieving funding equity because it applies a common formula to all schools of the same type and size: it is an equitable form of funding. It is under the centralised system that inequities in funding levels exist because of different seniority profiles among teaching staff.

2.8 It is true that current policy has favoured schools that opt for bulk funding. Prior to the 1998 changes, schools received average funding that meant that those that received above-average funding had less incentive to switch to bulk funding. Under the 1998 changes, all bulk funded schools became 'winners' in terms of funding levels. There was a clear inducement to schools to opt for bulk funding in terms of the quantum of funding made available, quite apart from the attractions of additional flexibility in their use. This muddied the waters by conflating the amount and method of funding and seemed unfair in so far as it was seen to favour schools with stronger administrative capacities. Those schools that were previously penalised by the centralised system had a greater incentive to switch. If every school were bulk funded, as the Picot committee recommended, then all schools would be funded on an equal basis, and funds could be better targeted to special needs. Under the centralised system schools with more experienced teacher profiles receive more funding, and abolition of bulk funding will tend to reinforce funding inequalities.

Union opposition as the real reason

2.9 We find no reason for abolishing bulk funding that makes any sense from a public policy perspective. The reason appears to be political and ideological: it would seem that the government is determined to do by legislation what the teacher unions could not do by applying industrial pressure on schools. As such, it puts teacher unions' power and influence above the interests of children's education.[3]

2.10 The opposition from the teacher unions to bulk funding illustrates two points about unions. First, the interests of those who run the unions may diverge from those of their members. Unions sell representational services. They have an interest in maintaining a centralised system to maintain their influence with the government and the demand for these services. Secondly, unions are political organisations and their members' interests are not always convergent. For example, non-performing staff may not gain from bulk funding and may resent the advantages accruing to high-performing staff who may be junior to them. It may be the case that it is senior non-performing staff who have most influence in union affairs and who can determine a union position at the expense of teachers who would gain from a move to bulk funding.

2.11 Arguments put forward against bulk funding have proved groundless. It has been argued, for example, that schools could not cope with the additional administrative burden, including employment issues. Another was that bulk funding was simply a device to enable governments to reduce funding to schools. In practice, schools have coped and funding has risen. Nor can it be argued that bulk funding has mainly benefited high socio-economic status (SES) students. Up to 1998, low decile schools were more likely to be bulk funded, now they are slightly less likely. In other words, the additional funding has been spread across all schools.

A pre-election commitment that must be honoured at all costs?

2.12 It may be argued that the abolition of bulk funding is a pre-election commitment that must be honoured. In general the keeping of commitments is certainly to be encouraged and applauded. However, there can be cases where not keeping a commitment is the lesser of two evils, and we think the commitment to abolish bulk funding is a case in point because the policy is wrong in principle and damaging to state schooling. In any case, commitments should follow careful analysis of the issue in question, and this does not appear to have been undertaken. We know of no government analysis of the costs and benefits of various ways of resourcing state schools, and which defends centralised resourcing against the other methods available including bulk funding. Indeed, the need to honour a commitment appears to be being used as an excuse for not investigating the issue thoroughly.

2.13 Moreover, even if electors vote after close examination of all party policies on offer, rather than simply on general impressions, they choose between 'baskets' of policies rather than endorse all policies in a particular 'basket'. In the case of bulk funding, schools that represent over 40 percent of all school children and their parents endorsed this method of funding through the parent-elected boards. Other schools opposed this method of funding, but their opposition provides no rational ground for denying other schools the choice. The pre-election commitment would seem in large measure to have been directed at the teacher unions which, as discussed above (2.10), have strong organisational reasons for opposing bulk funding.

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3 The unions have opposed bulk funding even though, since the funding changes consequent on the 1998 budget, all schools that took it up have received additional funding and have been able to pay teachers more and hire more teaching staff. However, it can reasonably be argued that the same employment effects might be obtained if bulk funding were abolished and the additional funding were spread across all schools. This would be true unless bulk funding schools are drawing on their operational grants to increase staffing, and we do not have information on this. The point would remain, however, that under bulk funding schools are using their funding in more efficient ways and according to local priorities – not according to standard national requirements determined by teacher unions and the ministry and applicable to all schools irrespective of circumstances.

Conclusion

2.14 No credible reasons have been provided in the Bill for the abolition of the bulk funding system that has been of significant benefit to the schools concerned and that was the subject of agreements entered into voluntarily by the schools in the interests of their own students. Arguments in terms of pre-election commitments and the interests of the teacher unions cannot be validly advanced against the educational interests of school students. We recommend that the Bill's provisions on bulk funding do not proceed.

2.15 The issue of funding mechanisms should be discussed in the broader context of developing the best environment in which schools should operate. Substantial local autonomy in staffing, as in other matters, should be part of that environment. This issue is discussed in section 4 below.

3.0 Enrolment schemes

3.1 There have been several changes in legislation dealing with student enrolment over recent years. The present Bill will tighten current legislation in several ways, principally in:

- requiring schools that are in danger of physical over-crowding to have a geographically defined home zone to which in-zone students are to have an absolute right of enrolment throughout the year. At present there is the somewhat looser requirement that schools in danger of over-crowding must have enrolment schemes that take account of the desirability of students being able to attend "a reasonably convenient school"; and
- setting out how out-of-zone students are to be selected. Schools will no longer have a role in student selection. Out-of-zone students are to be categorised in groups, which in order of priority are:
  - applicants for any special programmes;
  - siblings of existing students;
  - siblings of former students; and
  - all other applicants.

Selection within each group is to be by ballot. We note that children of former students are to be given no priority. It is claimed that this system is a fairer and more transparent way of determining enrolment where a school's capacity has been reached and to avoid over-crowding. We support fairness and transparency, but there are problems with enrolment schemes in general and with the provisions of the Bill in particular.

Fairness

3.2 'Fairness' in the sense of 'equality' of provision is extremely difficult to achieve because the distribution of such essential schooling 'resources' as educational leadership and high quality teaching cannot (even assuming measurement problems could be overcome) be equally distributed across schools or even within a single school.

3.3 Most schools with enrolment schemes already give priority to those students within a defined geographical area.[4] Thus, the enrolment scheme proposals try to increase fairness between a small sub-group of the school student population – those applying to an out-of-zone school. They will have, at best, a marginal impact on the distribution of students *across all schools* and on *overall* 'fairness'. However, the schemes will also have serious consequences for *individuals* and *particular* schools. Enrolment schemes will make the system less fair in some respects.

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4 See Wylie, C (1997), *Self-managing Schools Seven Years On: What Have We Learnt?*, New Zealand Council of Educational Research, p 156.

3.4 First, at present, it is possible for students to apply to attend an out-of-zone school that may better cater for their particular learning needs and abilities. There are also cases where it is important that a child goes to an out-of-zone school for entirely understandable personal reasons. For example, it is better for some children that they do not attend a school that their siblings also attend or at which a parent is a teacher. At present such personal circumstances can be catered for, but under the Bill's provisions this will not be the case. Secondly, there may be adverse effects on students from ethnic minorities and low-income families (see 3.7–3.10 below), some arising from changes in the property market (see 3.11–3.13 below).

3.5 It is important to note that the notion of fairness should focus on individuals and not on institutions. The concern should be particularly on low SES children and not on low SES schools. As Sowell points out:

> . . . the very concept of 'fairness' applies to relationships between *human beings* – not institutions. Institutions are merely the means to an end, that end being to serve human beings. There are no moral obligations to institutions which do not serve human purposes as well as other institutions. The most important fairness is fairness to children.[5]

We recognise that the Bill seeks to make selection fairer. But it mandates broad categories that cannot take account of the multiplicity of personal situations affecting children and their families and that can at present be addressed on an individual basis by school principals. In addressing some issues of unfairness the Bill has introduced others.

3.6 It is notable that to the extent that the Explanatory Note provides reasons for the provisions affecting schools it mostly talks of 'fairness' in institutional terms – that is of schools at risk of over-crowding and, by inference, of schools at risk of losing students to more favoured schools. It does not discuss the school choice needs of the most disadvantaged students, in particular the problems facing children from ethnic minorities and low SES backgrounds. The opposition to bulk funding has some of this same mistaken logic – it is claimed to be 'unfair' to schools that are not bulk funded.

'Fairness' and students from ethnic minorities and low-income families

3.7 There is some evidence that Maori parents and those from other minority groups make good use of whatever educational opportunities are available. For example, about 30 percent of this year's placements on the Targeted Individual Entitlement (TIE) scheme are Maori.[6]

3.8 Also the data on ethnic attendance patterns in the Smithfield Project[7] Report number 1[8] shows that the number of students exercising choice by attending adjacent schools when zoning was abolished "has grown, in particular for Maori

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5 Sowell, T (1993), *Inside American Education – The Decline, The Deception, The Dogmas*, The Free Press, New York, p 258.

6 Because Maori are disproportionately represented among low-income families, it can be expected that they would secure disproportionately more TIE places that are targeted at children from families where taxable income is less than $25 000 per annum and who are not asset rich.

7 The Smithfield Project was a longitudinal study tracking between 1992 and 1997 the impact of school choice policies on students, schools and their families in two urban areas of 11 schools each and in a rural area with one school. It was undertaken for the Ministry of Education. Several reports were prepared by various groups of authors that included Hugh Lauder (now University of Bath) and David Hughes (University of Canterbury).

8 Lauder, H, Hughes, D, Waslander, S, Thrupp, M, McGlinn, J, Newton, S and Dupuis, A (1994), *The Creation of Market Competition for Education in New Zealand*, first report to the Ministry of Education, March.

and Pacific Island Polynesian students" (p 32). From 1990 to 1993 the proportion of Maori students attending an adjacent school rose from 12 to 25 percent, and of Pacific Islands students from 10 to 28 percent (table 7, p 32). Both groups go from less likely to exercise choice under zoning than Pakeha to more likely under dezoning. The proportion attending distant schools stays at about the same level as it did under zoning for each ethnic group, Pakeha being more than twice as likely to attend distant schools as other groups.

3.9 Likewise, the Smithfield data show that most parents who took advantage of the extra choice offered by dezoning were from poorer than average backgrounds. The average student attending an adjacent school following dezoning was from a poorer family than those who did not exercise choice, a reversal of the position under zoning. The additional low-income people who exercised a choice under dezoning swamped the relatively well off, many of whom were already exercising choice under zoning.[9]

3.10 We are not aware of any evidence that would suggest that letting schools choose their own students would lead to discrimination on racial grounds. It is the case that Report 3 of the Smithfield Project[10] claims to show discrimination against Maori in admission decisions by high-status schools. The evidence presented does not apply to Pacific Islands students (as applicants they were among the most likely to be accepted) and can reasonably be interpreted as a case against rather than for zoning. The reason Maori students were less likely to be admitted could be due to preference being given to home zone students.

The equity effects of changes in the property markets

3.11 The introduction of a geographically defined zone means that places at a highly desired school will be allocated through the property market. As the demand for in-zone places increases, property prices and rents will rise relative to those for out-of-zone accommodation. Families that are able to afford more expensive houses and higher rents will 'buy' their children's enrolment into the school of their choice. Attempts to circumvent zoning by deception will increase. The less well-off will be effectively priced out of such schools. What at first sight appears to be an objective and transparent rule will lead to the very inequities that free education was supposed to address.

3.12 The proposal would have other adverse equity and efficiency effects. First, it would confer a windfall gain on owners of houses located in the geographical zones of schools that face excess demand. Secondly, changes in zones will become a contentious issue because they would have the potential to impose unanticipated windfall gains and losses on house owners, including those without school-age children. Thirdly, restricted access to desired schools will tend to impede labour mobility, thus making people less willing to take jobs in other localities. Fourthly, upward pressure on house prices and rents in areas facing excess demand may increase residential segregation and reduce the valuable social mixing that takes place outside of school.

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9 The Smithfield authors, in a list of findings, concluded that minority and low SES students are the least likely to be able to exercise choice. This seems contrary to their own data. The author's note that those who attend adjacent and distant schools are of higher SES then the average SES in their neighbourhood, but this does not mean that the poor are least likely to exercise choice. The additional families exercising choice are relatively well off for the neighbourhood, but relatively badly off compared with the average New Zealand family. Their empirical evidence, rather than their conclusions, is quite supportive of dezoning. See also Gorard, S and Fitz, J, 'Under Starter's Orders: the established market, the Cardiff study and the Smithfield project', *International Studies in Sociology of Education*, Vol 8, No 3, 1998, pp 299–314.

10 Lauder, H, Hughes, D, Watson, S, Simiyu, I, Strathdee, R and Waslander, S (1995), *Trading in Futures: The Nature of Choice in Educational Markets in New Zealand*, third report to the Ministry of Education, December.

3.13 Thus, such evidence as exists suggests that tightening enrolment provisions may disadvantage the already disadvantaged. If so, the enrolment provisions may run counter to the government's aim to 'close the gaps', which is presumably motivated by a concern for 'fairness' in the sense of greater equality of educational outcomes.

Effects on school effectiveness

3.14 The enrolment provisions may also have the effect of propping up failing schools with excess capacity as a result of 'pupil flight' by restricting movement out-of-zone and denying schools facing excess demand the resources with which to expand. This will be unfair on many children. We are concerned with the emphasis, for example in clauses 11A(1)(c) and 11E(2)(c) of the Bill, on making the best use of existing schools without any reference to the quality of schooling that takes place within them and the situation of educationally disadvantaged children. Again, the interests of institutions are given priority over the interests of children.

3.15 The enrolment provisions may also have adverse effects on the operations of successful schools by removing control over school mix, which could be a factor in their success. A school may be hindered in developing a particular identity and school ethos and in catering for students who will benefit most from what the school has to offer. It may force schools into expensive additional provision for students they would not normally cater for. The lack of any priority for their children in enrolment (3.1) will reduce the interest and enthusiasm of former students in supporting the school in governance and administration, in sports and cultural activities, and in fund raising. Over time the erosion of the loyalty and commitment of former students to the school may well change a school's ethos, reduce its morale, and be to the considerable disadvantage of the current students.

3.16 The provisions will also reduce the incentives on students to achieve selection at an out-of-zone school. If selection is by ballot there will be no point in working hard to gain admission at a school that places high importance on, say, music or academic standards because selection will be entirely random and not dependent on 'fit'.

School mix or 'peer' effects

3.17 Another possible objection to school selection is that if peer effects are important, it will lead to segregation by ability and those in low ability classes will lose. This may, of course, already occur through streaming within 'mixed ability' schools. It may also be argued that if ability is correlated with ethnicity and SES, selection by schools may result in segregation by race and SES. However, depending on how school mix works, it could make disadvantaged students worse off, for example, by preventing a school from specialising.

3.18 The school mix (or peer) effect may result from effort put in by schools to develop a school ethos and to select appropriate students. If schools are denied the right to select students, they will be prevented from controlling their peer group and from gaining the externalities that result. Forced 'mixing' will reduce the incentives for schools to provide appropriate education. Peer effects depend on behaviour, and behaviour responds to incentives.

3.19 The evidence on school mix effects in New Zealand is, in fact, weak. The most careful study[11] on the question came to the conclusion that "the hypothesis that the ability or social class composition of a school has an independent effect on a school's performance is shown to be doubtful".

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11 Harker, R and Nash, R, 'Academic Outcomes and School Effectiveness: Type "A" and Type "B" Effects', *New Zealand Journal of Educational Studies*, Vol 32, No 2, 1996, pp 143–170.

3.20 In spite of the lack of clear evidence about school mix effects, they have been the main focus of education provider interests in their attack on school choice, and there has been relative neglect of other school effects.[12] The following points might be made in summary:

- It is not clear whether peer effects exist (Harker and Nash *op cit*).
- If peer effects do exist, it is not clear that the peer effects of dezoning are detrimental. The evidence is that SES mixing increases with dezoning and that many low SES and minority students gain. There is a concern that some students are left behind in declining schools, but there is little evidence that they are worse off. Greater specialisation may be beneficial.
- Even if there are detrimental peer effects from dezoning, they are not the only influence on academic achievement. The other effects of the changes, like improved incentives, better matching of student with school and greater parental involvement may more than outweigh any adverse peer effects. For example, dezoning permits students to move to preferred schools and bad schools have an incentive to improve. The problem may be that bad schools are kept open when they should be closed or have their management replaced.
- If there are detrimental peer effects, the solution is not necessarily zoning or regulation of enrolment schemes. There may be more effective and less costly ways to help those who are disadvantaged, for example by replacing poor-performing management and teachers.

The local state school as the preferred school

3.21 An underlying assumption in these provisions of the Bill is that the local state school is the preferred provider of schooling services. This would be reasonable if all schools are of the same high quality and all student learning needs were essentially similar. But, of course, this is not so. Although all state schools are subject to the same extensive regulatory controls, they differ widely in educational quality and hence in popularity among parents. School children differ widely in their learning needs and so do parental expectations of schools.

3.22 Thus, in our view, a fundamental concern of any reform should be 'diversity plus excellence' in the interests of all children and not 'homogeneity plus mediocrity'. The piecemeal pursuit of 'fairness' out of the context of this wider concern can be counterproductive and have perverse results. Children have different abilities and learning needs, and at the secondary stage of schooling a wide range of curricular options is required. The higher retention rate in the senior secondary school means that a much wider range of ability, attainment level and post-school aspiration is represented in it. To admit this is not to be elitist but is the first necessary step towards building a more effective school system that is fairer to all.

Conclusion

3.23 Enrolment schemes may sound fair and reasonable but can in fact have inequitable results, not least for the most disadvantaged. As in the case of bulk funding, we know of no government analysis that reviews enrolment arrangements, identifies their advantages and disadvantages, evaluates them against possible alternatives, and defends the proposed arrangements against those alternatives. Our analysis

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[12] See, for example, the Smithfield reports and Wylie, C (1998), *Can Vouchers Deliver Better Education: A Review of the Literature with Special Reference to New Zealand*, New Zealand Council of Educational Research, Wellington. An example of the hostility is the statement by Darrell Ward, the President of the New Zealand Educational Institute (the primary teachers' union), that flexibility and choice are the "F and C" words of the 1990s (reported in the *New Zealand Education Review*, 24 September, 1999, p 4).

indicates that the proposed changes will be retrograde and we consider that they should not proceed.

3.24 Policy should aim at creating an environment in which all schools have clear incentives to improve. This requires less external control on schools and more local discretion, including over student selection. This broader approach points to funding mechanisms to promote greater institutional autonomy with schools more accountable directly to parents through school choice. Pending the development of such policies, present enrolment provisions should remain.

3.25 The main policy concern should be the government's control over the supply of schooling, that is over the number, location and capacity of schools. Dezoning does not result in a genuine 'market' outcome because of these very considerable constraints. From this perspective, enrolment provisions are a second-order issue, though of considerable importance to particular schools and particular students. We turn to some of these wider issues in the following section.

4.0 Effective schooling, choice and competition

The State as a monopoly supplier of schooling

4.1 Several of the basic problems facing the state school system arise from the fact that it is a virtual monopoly. The private schools sector accounts for less than 4 percent of all school children compared with about 30 percent in Australia. Most private schools, including the large Catholic school systems, have integrated into the state system while being allowed to maintain their religious or other distinctive ethos and ownership of fixed assets.

4.2 Thus, state schools face very little competition from private schools which, because of the low state subsidy levels, have to charge substantial fees that many less well off families are unable to afford. The abolition of the TIE scheme from next year and the freezing of the private school subsidy will reduce still further the ability of the remaining private schools to compete with state schools.

4.3 Furthermore, the ability of state schools to meet the diversity of parental expectations and student needs is very curtailed. All state schools have to deliver to the same extensive curriculum and pay teachers according to a national award. State schools have relatively little control over finances and property. Easing out non-performing teachers is possible, but can be a time-consuming and difficult process. The shadow of the Employment Court overhangs the process, adding to the complications, uncertainty and costs. Given this situation it would be surprising if there are not significant numbers of teachers who should not be teaching. The abolition of bulk funding (see section 2 above) will remove some existing freedoms with regard to staffing arrangements, as will the Employment Relations Bill by adding to the costs and uncertainties of employment, including employment of temporary staff.

4.4 There is little reliable information on student performance. Some of the information that is available, for example the comparative data from the International Association for the Evaluation of Educational Achievement (IEA) international surveys, is worrying. The government's decision to abolish the proposed trial of national testing at the primary level is unfortunate in this regard. The effects are to bolster the state school monopoly and to protect schools within it from criticism of low performance. By and large, monopolies resist independent evaluation of their effectiveness. This is certainly the case in schooling as evidenced by the widespread outcry by education provider interests against national testing and anything that might look like a performance league table. However, parents, the 'consumers' of education, clearly want more and better information about the performance of their children's schools and of their own children.

4.5 A productive approach would be to consider the incentive structure under which schools operate and to seek to change it so as to give greater encouragement to all schools to raise their performance and to meet the diverse learning needs of all their students.

Effective schooling

4.6 There is a considerable amount of literature on what makes for effective schooling. The usual empirical approach is to take schools with similar student population characteristics and to seek to identify why some of them do well and others poorly. Characteristics found consistently to be correlated with success include: strong educational leadership from the principal, an emphasis on acquiring basic skills, a collegial approach among the teaching staff, a safe and orderly climate, high expectations, and regular assessment against those expectations.[13] None of this is particularly surprising: the findings resonate with what might be expected in many, if not most, kinds of enterprises.

4.7 A well-known study further identified school organisation as a key factor in effective schooling (along with student aptitude, family background and peer group influence) and found that the less a school is subject to pressures outside the school, specifically from external administrators and teacher unions, the more likely it is to be effectively organised.[14] Again, this is not particularly surprising: successful enterprises usually give a high degree of autonomy to local managers. Organisations that subject local managers to significant 'top-down' control are unlikely to attract enterprising and capable employees, and any move to reduce the discretion of school principals will have an unfortunate effect on the state school system's ability to attract and retain able teachers.

4.8 A recent study[15] identified common elements among seven successful, low-income schools in the United States, the first one of which is "Principals must be free". "Effective principals decide how to spend their money, whom to hire and what to teach", and . . . "innovation and flexibility are the keys to their success". This is a very small scale survey, but the findings confirm what is intuitively to be expected.

4.9 Quite what weighting should be put on the various factors contributing to effective schooling can be, and is, disputed. Nevertheless, the general message about what is important is clear enough, and it strongly suggests that the bulk funding and enrolment changes in the Bill go in the opposite direction to that indicated by research. Principals will have less freedom not more and, other things being equal, school effectiveness is likely to suffer.

The effects of choice and competition on school performance

4.10 It is also the case that empirical studies, mostly American, show that competition raises educational standards. The evidence is often drawn from comparisons of changes in attainment levels of students in private (Catholic) and state schools after controlling for differences in student bodies.[16] In some cases it has been found that disadvantaged groups were the main beneficiaries of the higher performance of

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13 See, for example, Jaap Scheerens, (1992), *Effective Schooling – Research, Theory and Practice*, Cassell, London.

14 John Chubb and Terry Moe, (1990), *Politics, Markets, and America's Schools*, The Brookings Institution, Washington.

15 Carter, S C (1999), *No Excuses*, The Heritage Foundation, Washington DC.

16 See, for example, Chubb and Moe 1990.

private schools. A US study found that urban minorities gain the most from Catholic schooling because they face the worst public school alternatives.[17]

4.11 Some of the empirical evidence suggests that:

- Competition between schools improves performance. For example, an increase in public school choice improves student achievement and reduces costs. Moreover, the response increases with the financial penalty attached to losing students.[18]
- Private control over school output generally increases student achievement and the effects of private schools on achievement were either independent of family socio-economic status or higher for the lower status groups.[19]
- The centralisation of school finance and control is bad for educational outcomes.[20]
- Unionisation has a negative effect on student achievement.[21] A recent survey summarises the evidence as "the general sense that is emerging suggests a negative role for unions when isolated from competition through a centralised bureaucracy".[22]

Conclusion

4.12 In contrast to the direction indicated by this research, the thrust of the bulk funding proposals is to maintain or increase teacher union influence and central bureaucratic control at the expense of flexibility in resource use, while enrolment provisions will reduce competition in the interests of stability in the use of existing state school capacity irrespective of the consequences on the effectiveness of education.

5.0 School governance

5.1 The Bill provides for greater continuity in board membership, some changes to merger provisions, ministerial approval of alternative constitutions in certain exceptional circumstances, and removes a discretion that allows a board not to have a student trustee.

5.2 We note the curious fact that at the same time as boards are being reconstituted in the interests of more effective governance, their powers to allocate funding and to determine school enrolment schemes are being reduced. These reductions in board

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17 Neal, D, 'The Effects of Catholic Secondary Schooling on Educational Attainment', *Journal of Labor Economics*, Vo 15, 1997, pp 98–123. For a survey of the literature, see Neal, D 'What Have We Learned about the Benefits of Private Schooling?', *Federal Reserve Board of New York Economic Policy Review*, Vol 4, No 1, March 1998, pp 79–86.

18 For a survey of the literature, see Hoxby, C, 'What Do America's "Traditional" Forms of School Choice Teach Us about School Choice Reforms?', *Federal Reserve Bank of New York Economic Policy Review*, Vol 4, No 1, March 1998, pp 47–59.

19 Toma, E, 'Public Funding and Private Schooling across Countries', *Journal of Law and Economics*, Vol XXXIX, No 1, April 1996, pp 121–148. This used an international data set that included data for New Zealand.

20 Chubb and Moe, *op cit*, 1990; Peltzman, S, 'The Political Economy and the Decline of American Public Education', *Journal of Law and Economics*, Vol 39, No 1, 1993, pp 73–120; Peltzman, S, 'The Political Economy of Public Education: Non-college-bound Students', *Journal of Law and Economics*, Vol 99, No 1, 1996, pp 73–120.

21 Peltzman, *op cit*, 1993 and 1996; Hoxby, C, 'How Teachers' Unions Affect Education Production', *Quarterly Journal of Economics*, Vol 111, No 3, August 1996.

22 Nechyba, T (1998), 'The Economics of Education: Vouchers and Peer Group Effects', speech to the New Zealand Association of Economists.

powers will inevitably reduce whatever beneficial effects the governance changes would otherwise have.

5.3 Nevertheless, we support the proposed changes with one exception. The changes recognise that different local circumstances require different solutions. This recognition and resulting policy are at odds with what is proposed for bulk funding which, contrary to the rhetoric, denies the importance of flexibility and the need to provide for local solutions to local problems. The reason for this difference is, presumably, that changes to board structure and terms do not threaten the power and influence of the teacher unions and are thus not opposed by them.

5.4 The exception to our general support of the governance changes is the provision to remove a secondary school board's discretion not to have a student trustee. We do not consider that student representation is generally desirable because of the potential for conflict of interest, although we would not wish to remove boards' discretion in this matter. We understand that in many cases it works well. However, in some schools at some times there may not be a suitable student representative and this possibility should be recognised. There are other ways of assessing student views than having a student representative on the board. The same potential for conflict of interest exists, of course, with having teachers on the board.[23]

5.5 We see the proposed changes to governance as relatively minor variations in the *Tomorrow's Schools* policy of the previous Labour government. In it boards of trustees are the essential link between parents and professional teaching staff and, via the charter, between the government and the school. While this was, in many respects, an advance over the previous cumbersome administrative arrangements, we see the desirability of taking reform to a further stage. Parents are not necessarily good school governors, but more importantly boards lack accountability, there are inherent measurement problems, and there is a lack of significant pressure on schools to be responsive to parental expectations.

5.6 Parents' choice of schooling for their children is far more important than their involvement as governors. Parents are 'consumers' of education on behalf of their children and are not necessarily good governors. Schools need to be accountable directly to parents and not accountable weakly and very indirectly via infrequent board elections. Open competition between alternative suppliers is the strongest safeguard of consumers' interests. In education this requires both funding of parents via a voucher or similar mechanism and giving state schools much more freedom in terms of their use of resources, control over staff and choice of curriculum.

5.7 A move in the direction we would wish school reform to proceed would be along the lines of the charter school movement in the United States. Charter schools are public schools run by community or other organisations with varying degrees of exemption[24] from the usual regulatory controls relating to curriculum, staffing and so on. We consider that liberal provision for similar exemptions should be included in the Bill.

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23 Trustees who are students or teachers are excluded from meetings at which their conduct or, in the case of a staff member, employment *as individuals* is to be discussed (paragraphs 9–10, 6th Schedule, Education Act 1989). This does not, of course, address the broader issue of potential conflict between the board with its school-wide interests on the one hand and the interests of students or teachers on the other.

24 Charter school legislation varies from state to state within the United States.

Conclusion

5.8 We support the proposals with the exception of the provision to make student representation on a school board compulsory. We consider, however, that the provisions should be extended to provide for 'charter schools' status under which approved schools could have extensive exemptions from curricular, staffing, financial and national award requirements.

6.0 Tertiary students' associations

6.1 The Bill seeks to promote collective organisation and representation of student interests and to protect the right of students to exercise democratic choice over whether membership of a students' association should be compulsory or voluntary. It removes a bias in present legislation in favour of voluntary membership of tertiary associations. The Bill amends the 1998 legislation that brought in voluntary membership.

The new provisions

6.2 The main new features of the Bill are:

- The removal of the present provision that membership of a tertiary student association is voluntary unless a referendum of students determines that it be compulsory. Under the Bill associations can move between voluntary and compulsory membership under the same processes (new section 229D).
- Under the Bill a Council *must* collect fees if asked to do so by an association that meets certain criteria and without charge. At present a Council "may" collect such fees.
- Under the Bill, exemptions will be controlled by the associations and not, as at present, by the Councils. The Bill further provides that where exemption is granted on conscientious objection grounds the association concerned will send the fee to a charity of its own choosing.
- Present provisions requiring equality of association funding for promoting compulsory and voluntary membership are to be removed.
- Present provisions about undue influence on students regarding membership of an association are to be removed.

Comments

6.3 Providing for compulsory membership of an incorporated society infringes liberty and is oppressive. It should only be contemplated where there is an arguable case for protecting the interests of the public against misconduct or incompetence. But such a consideration does not apply in the present case, and we know of no other similar situation where membership of an incorporated society is made compulsory by legislation. The current provisions are inconsistent with the principle of freedom of association and some of the particular provisions in the Bill make the situation even worse. Higher education should be characterised by freedom of expression and openness to diversity of opinion, and in terms of membership of institutional organisations individual autonomy should prevail. Academic staff are not legally required to join a staff association, and it can reasonably be supposed that many would object most strongly to any such proposal.

6.4 There are two main arguments against the view that state tertiary institutions should be free to decide whether association membership should be compulsory or not. First, student associations are representational and political. There can be, of course, no objection to students engaging in politics, but it is unconscionable to require membership of such organisations. Secondly, tertiary institutions have quasi-monopoly status, and vesting coercive power in non-elected state-controlled institutions, whether in their Councils or in student associations, is undemocratic because students wanting a university education have no alternative but to attend a state university. Private Training Establishments (PTEs) on the other hand are far more numerous and not state-owned or controlled and should not be subject to legislative requirements on student associations: it should be left to each PTE to decide its own policy on such matters.

6.5 The opportunity to gain an exemption does not make compulsory membership acceptable. It is in fact totally bizarre that legislation should have to provide exemption on conscientious grounds from membership of an incorporated society. Such provisions are usually only required in cases such as exemption from military service in times of national peril. Also, in practice, obtaining an exemption can be time consuming and, in the case of exemption for conscientious objection, without financial benefit. The Bill makes matters worse by giving to associations the responsibility to decide to whom exemptions will be given and to what charities fees from those on whom they confer conscientious objector status should be sent. To give the same body from which one seeks exemption the right to decide on exemptions is contrary to natural justice. The lack of any complaint or appeal procedure makes this aspect even more worrying.

6.6 The Bill aims to remove the bias towards voluntary membership by providing the same procedures for moving from compulsory to voluntary membership as for going in the opposite direction. In practice, the provisions will provide a relatively easy route for activist minorities to change or retain membership requirements. They will be well placed to marshal the required numbers of students to achieve control over the relatively disorganised, often uninformed and apathetic, majority. The appeal of compulsory membership, including the very considerable financial advantages, provides an enormous incentive to retain or to regain compulsory membership.

6.7 The appeal of compulsion is exemplified by the very sharp falls in membership and income that occurred at the universities of Waikato and Auckland which moved to voluntary membership under the 1998 legislation. The Waikato students' union is reported to have 2000 members out of the 13 000 students currently attending the university (*New Zealand Education Review*, 31 March, 2000). The New Zealand University Students' Association (NZUSA) will also have suffered losses of revenue as a result of the move to voluntary membership at these two universities. It has had to change its constitution so a constituent union pays fees to it on the basis of its actual membership and not, as until recently, on the basis of student numbers.

6.8 It should be noted, however, that it is the Councils who are to decide, in consultation with any associations, the rules under which votes are to be conducted. Presumably, a Council could require, for example, a two-thirds majority of all students, rather than a simple majority of those who vote, to effect a change to voluntary or compulsory membership, and if such were to be the requirement a change would be much more difficult to effect. We anticipate that Councils will argue that it is in the interests of 'harmony' for them to set low thresholds.

6.9 Whatever the voting procedures to be chosen, the government should not allow compulsory membership of student associations at state-owned institutions. Student associations may express strong views of a political and ideological kind and they are not limited to providing student services and advocacy. It is intolerable that students holding different views should be required to join (or go through the highly flawed exemption process to escape membership of) an association expressing views with which they disagree and may even find morally repugnant.

6.10 It may be argued that the efficient delivery of association services requires compulsory membership. But associations can offer advocacy and other services to their members, and non-members requiring similar services can go elsewhere for them. There may be some economies of scale, but the government does not require all motorists to join the Automobile Association or subscribe to the *Consumer* magazine on such grounds. In practice, of course, monopoly situations with compulsory membership inevitably lead to complacency, disregard of minority views, ineffective and costly service delivery, and apathy among members who can do little if anything to effect change.

6.11 Arguments for compulsion are hard to find while arguments against compulsion are compelling. It would seem that the main reasons for the Bill are the government's 'partnership' view of the relationship between student associations and Councils. This would seem to combine with the desire to privilege favoured groups, namely student associations, and to give student activists, often representing a minority of students, a degree of legitimacy that is unwarranted.

6.12 The 'partnership' view advanced in the Explanatory Note is not explained nor is it defended against other possible models of tertiary governance. It may be convenient for a Council to have a single student association with compulsory membership with which to deal and to claim that having association representation on it necessarily means that students are being consulted. However, associations with compulsory membership are not likely to represent the diversity of student views, and Councils should employ a wide range of ways of assessing student opinion.

6.13 It is unwise to deal with the issue of student representation on Councils outside the wider context of tertiary governance. The issue needs separate and careful treatment. Mandatory student representation is not usually desirable. An institution's governance arrangements and other aspects of organisational design should be determined in the context of its objectives, the need for decision-making processes that enable objectives to be effectively pursued, and the requirements of accountability, monitoring and incentives for high performance. It is not clear that the same organisational requirements should apply to all types of state tertiary institutions, a point that may be underscored by the government's concern for greater discrimination between the roles of the various types of institution.

Conclusion

6.14 We do not support the relevant amendments and recommend they do not proceed. They make existing provisions worse, offending the usual notions of natural justice in several important respects by giving priority to institutional interests over individual freedom.

6.15 We consider that compulsory membership of student associations in state tertiary institutions should be specifically prohibited, just as compulsory trade union membership has been eliminated and is not being reimposed by the Employment Relations Bill. It is not desirable for the government to legislate for student associations at PTEs. The issue of student representation on Councils should be considered in the wider context of tertiary governance and, pending such a review, present arrangements should stand.

7.0 Compliance with the Human Rights Act 1993

7.1 The Bill contains four clauses that remove from education legislation the exemption from compliance with the Human Rights Act 1993 that applies presently to government policies and practices. These provisions are as follows:

- The principal Act provides that the Secretary for Education may, on the recommendation of the chief executive of the department responsible for the administration of the Children, Young Persons, and Their Families Act 1989, direct that the board of a state school enrol at the school any person under 18. Clause 5 of the Bill removes the age limit.
- The Royal New Zealand Foundation for the Blind Act 1963 provides that the minister of education may direct the Foundation to admit to, and maintain in, one of its institutions, establishments or accommodations any blind person between the ages of six and 20. Clause 26 of the Bill removes the age limits.
- The Private Schools Conditional Integration Act 1975 provides, at section 77, for the retirement of teachers in integrated schools at certain specified ages. Clause 27 of the Bill removes these provisions.
- The Music Teachers Act 1981 provides that the Institute of Registered Music Teachers shall not register anyone under the age of 20 years. Clause 28 removes the age limit.

7.2 The proposed amendments end exemptions for various age restrictions in education legislation from compliance with the Human Rights Act 1993. We are not told in the Bill's Explanatory Note the original reasons for the restrictions or why their removal is now desirable other than the need for compliance with the Human Rights Act 1993. In the absence of this information we are unable to come to a view about them. We would, however, be concerned if there is an inference that any age restriction is discriminatory as, in our view, there can be no simplistic equation of age restriction with discrimination. Our preference would be to retain the exemptions pending a more detailed review of their merits and of the Human Rights Act 1993 itself.[25]

Conclusion

7.3 In the absence of detailed information about the exemptions we are unable to express an opinion on the merits of removing them. Our preference would be to maintain the exemptions pending a more detailed review of their merits and of the Human Rights Act 1993 itself.

8.0 Recommendations

8.1 It is recommended that the Select Committee:

- decline to support the abolition of the 'fully funded' (bulk funding) option (section 2);
- decline to support the changes to enrolment provisions (section 3);
- note the importance of freeing up the supply side of schooling and of direct accountability of schools to parents and promote the introduction of a liberal voucher scheme for the funding of schooling, with vouchers 'cashable' at both state and private schools (section 4);
- decline to support the proposal that student representation on school boards be compulsory and support the other proposed changes to state school governance provisions (section 5);
- promote the inclusion in the Bill of 'charter school' provisions enabling the minister to confer on approved schools wide exemptions from present

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25 For discussion on human rights legislation see Epstein, R (1996), *Human Rights and Anti-discrimination Legislation*, New Zealand Business Roundtable, Wellington; and Epstein R (1999), *Age Discriminations and Employment Law*, New Zealand Business Roundtable, Wellington.

regulatory requirements and from the national teacher industrial awards (section 5);

- decline to support the proposed changes to provisions concerning tertiary student associations and promote the legislative prohibition of compulsory membership of student associations at state tertiary institutions and the removal of provisions concerning tertiary student associations from legislation relating to PTEs (section 6); and
- note our preference to retain present exemptions from the Human Rights Act 1993 pending a detailed review of their merits and of the Act itself (section 7).

APPENDIX A

EDUCATION FORUM

The Education Forum has been formed to contribute to education policy through research and debate on the current issues, structures, and expectations at all levels of New Zealand education.

The Forum believes that New Zealand education requires an approach to learning and achieving that encourages all individuals to reach their full potential, and that will take New Zealand to the leading edge of international performance and achievement.

The Forum is an association of individuals who have a common concern for the future direction of New Zealand education. The membership is drawn from primary, secondary and tertiary sectors of education, together with leaders of industry and commerce.

The principles incorporated in the above statements include the following:

- A commitment to excellence and high expectation in all human endeavour, based on a lifelong desire for learning.
- The belief that the community/government should ensure that all young New Zealanders have access to quality education.
- The teaching of values and life skills that will preserve the dignity of the individual and the integrity of the family.
- The acceptance of healthy competition for both individuals and the education sector.
- The encouragement of cooperation, creativity, adaptability and enterprise.
- The encouragement and recognition of personal responsibility, goal setting and achievement in all endeavours, through self-discipline and hard work.
- The acceptance of a compulsory core curriculum in primary and secondary schools.
- The necessity for high standards of assessment of student performance and of accountability of teachers and institutions.
- The promotion of a New Zealand cultural identity.
- The key involvement and responsibility of parents in their children's education.
- The emphasis on the value of parental choice and the self-management of education institutions.
- The development of closer links between education institutions and industry.

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APPENDIX B

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Avondale College

Mr John Taylor
Headmaster
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ARTICLE BY ROGER KERR
FOR THE *NEW ZEALAND HERALD*

LABOUR LAW FOUNDED ON A FALLACY

APRIL 2000

LABOUR LAW FOUNDED ON A FALLACY

Labour markets in large parts of the United States today are operating at close to full employment. Far from destroying jobs, advances in technology are creating a seemingly insatiable demand for labour in the technology industries. Wages are rising, even for those workers with the lowest skills. Immigration restrictions are being eased.

The lengths to which some firms are going to obtain staff are extraordinary. When one Silicon Valley firm announced a large layoff, another in the same industry hired a plane to fly over its headquarters hauling a banner with its name and Web address offering employment.

Is this a picture of a labour market operating on the principle that employers have monopoly power over employees, as labour minister Margaret Wilson asserts? Of course not. The whole notion that employers can force wages down is simply a Marxist fallacy. If it were not, how did wages ever get above subsistence or regulated levels for the great majority of workers? The reality is that competition and productivity force wages up. No individual employer can stop competitors from offering jobs at the going rate or above. Nor can any employer stop an employee from taking one of those jobs, subject to the terms of any employment contract.

Like any other market, labour markets are affected by fluctuations in supply and demand. At times there may be a buyer's market or a seller's market for particular skills in particular locations. But neither employers nor employees have systematic, long-run bargaining advantages in well-functioning labour markets – the notion of 'unequal bargaining power' is a hoary myth.

The Employment Contracts Act 1991 (ECA) is based on this understanding of labour markets, but the Employment Relations Bill (ERB) is founded on quite different premises. Essentially, it aims to counter purported monopoly on the employer side of the market by monopoly structures on the other side. The government is saying it wants to promote competition in the economy through changes to the Commerce Act 1986 yet it is restoring monopolies in the labour market and accident insurance.

The upshot is a strong push towards collective bargaining in the ERB, despite the fact that collective agreements now cover a relatively small proportion of the workforce. New employees in a firm covered by a collective agreement must be members of it for the first 30 days, and collective agreements have numerous advantages under the Bill that individual agreements do not have.

Even if the flawed logic for favouring collective agreements were accepted, there is no reason why any bargaining agent could not negotiate them, as is the case under the ECA. And here is the next rub: under the ERB, only unions can negotiate and be party to a collective agreement. The Bill's hidden agenda is to restore privileges to unions.

Monopoly pressure on wages can only be exercised by unions if they can restrict the supply of labour. They can do this in two ways. One is to make it harder for non-union labour to get jobs at all. Thus, for example, the ERB prevents firms from employing non-striking labour, and outsourcing and fixed-term contracts are made more difficult. The other is to stop anyone from undercutting the cost of union labour – hence the device that prevents new workers from starting on a lower package than the collective package and the concept of coverage, which means that an agreement covers certain work rather than being a relationship between particular people. These are blatant attempts to fix prices and deny new employees freedom of contract.

Restoration of union privileges will have predictable consequences. 'Insiders' – those in secure jobs – may benefit, at least until the impacts on economic performance are felt, and their position will be reinforced by provisions that make dismissals more difficult. 'Outsiders' – those seeking jobs – will find it harder to compete. The New Zealand labour market will move in the direction of those in social democratic countries in Europe where unemployment remains stuck at around 10 percent. The chances of achieving US-style full employment or the prime minister's goal of a 3 percent unemployment rate will be negligible.

The ECA does not 'tilt the playing field' towards employers, as union rhetoric suggests. It established essentially the same conditions for bargaining as apply in other markets. Consumers may face 'take it or leave it' offers from banks or department stores, but they are protected by competition in the markets in which those firms operate.

In the labour market, by far the best protection for a worker against a 'bad employer' is the ability to quit a job, subject to the terms of a contract, and readily find a new one. An employer's best protection against a 'bad worker' is the ability to dismiss, subject also to contractual terms. These protections are best afforded by free and open competition that drives labour markets to high levels of employment, not by extensive regulation that undermines that goal. That is the lesson from the US economy today.

By contrast, the Employment Relations Bill, based as it is on the concept of a class struggle between workers and owners of capital, overlooks completely the need to protect workers, firms and the unemployed from the abuse of state-conferred union privileges. It is regrettable that a Labour/Alliance government is putting union interests ahead of the interests of all other parties.

AUCKLAND UNIVERSITY OF TECHNOLOGY CONFERENCE
SEIZING OUR FUTURE

CHALLENGES FROM BUSINESS

BRYCE WILKINSON
DIRECTOR
CAPITAL ECONOMICS

WELLINGTON
29 FEBRUARY 2000

CHALLENGES FROM BUSINESS

Introduction

First, I wish to congratulate the Auckland University of Technology for attaining university status and for holding a conference on such an important and timely topic. Universities are commonly facing difficult times. Newer entrants need not have the baggage and rigidities of incumbents. They may be better able to seize opportunities. New Zealanders need best value for money from providers of tertiary education and I am sure we all wish the Auckland University of Technology well in its search to provide it.

Educational institutions are a business. The challenges they face – getting students to enrol for their courses and meeting a budget – have a clearly recognisable business characteristic.

Students who are studying commercially oriented courses want jobs that use their skills when they graduate. Businesses seek employees with the right skills for the job. They also seek new ideas and technologies and access to a plentiful supply of customers. Providers of tertiary education can supply the graduates that businesses require and much technical expertise.

Businesses and students can buy the educational services they require locally or internationally. They can do the latter directly. Alternatively, a local provider could act as a conduit that adds value on the way through.

The new computing and communication technologies are greatly reducing the costs of doing business. They are also reducing many of the costs associated with distance. From the point of view of a tertiary education provider this is both a challenge and an opportunity.

In New Zealand, as in many other countries, educational providers are also facing many challenges of a local origin. Many of these challenges arise from the constraints caused by widespread government ownership, regulation and distortions to prices caused by high tuition subsidies and non-neutral funding. Others, not entirely unrelated, are associated with changes in the demand for skills and in the proportion of any age cohort that obtains a tertiary education.

A journalist described recently the following as an optimistic view:

> We are living in a bizarre world. It is the worst of both worlds – the negatives of state control and the negatives of market competition. We have futile competition and massive duplication. We have an industrial relations system left over from the Dark Ages. We have pathetic salaries, and most of the good staff are looking to go overseas.[1]

For those with whom those words strike a chord the speaker was not referring to New Zealand. The vice-chancellor of Murdoch University in Perth was cited as making these comments on the situation in Australia as he saw it. Murdoch University is reportedly the only Australian university to have received the highest five-star rating in every edition of the *Good University Guide*. The rest of the article referred to operating deficits, staff cuts in science departments, a 40 percent increase in the ratio of staff to students in a decade as student numbers increased by 50 percent, a net loss of professionals, enormous wastage from student attrition and uncompleted courses.

In short, there are plenty of risks, challenges and opportunities for universities as businesses. Government policies particularly distort and constrain educational providers

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1 'Universities: "Worst of both worlds" ', *Otago Daily Times*, 25 February, 2000.

and the business environment more generally. Partly because of widespread voter ignorance about basic economic propositions, policies may be based on erroneous and self-serving ideas. This leads to instability because, typically, policies that confer privileges based on unsound arguments are endlessly modified and eventually reversed. Despite their interim benefits, they can put institutions at risk.

In the remainder of this address I elaborate on these remarks.

Location: the international dimension

Location is important. Local providers of tertiary education have a natural advantage in satisfying the needs of local businesses and students. Strong links are possible between local tertiary institutions and those firms that rely on graduates and advanced technologies for their competitive edge, as the development of Silicon Valley illustrates. The links occur *inter alia* through the production and hiring of graduates, the design and content of courses of tuition and through contracting and research.

Michael Porter, of Harvard University, has stressed the importance of clusters of excellence and specialisation in economic development. Italian footwear, Swiss clocks, Danish pastries, French wine and cheeses and Silicon Valley come to mind.

Competition inside the cluster provides the yardstick for establishing which ideas and products are the most valuable commercially. Competition spurs innovation, creates choice and allows diversity to flourish. The opportunities opened up by creative minds, new ideas and businesses that are capable of exploiting them creates an exciting environment. Others are attracted because they can feed off the excellent educational institutions, the pool of skilled graduates, or the products created by the existing firms in the cluster. Soundly based clusters of excellence can create virtuous circles.

Clusters of excellence provide a resource that all can tap into. Locals can tap into them most cheaply. But it is impossible to be close to every cluster of excellence because they are distributed around the globe.

A well-established cluster may achieve a virtually unassailable dominance for a prolonged period. For example, New Zealand cannot hope to excel across-the-board in tertiary education on its own. Educational excellence has been achieved in the United States at the tertiary level. An abundance of Nobel laureates live in the United States. There are many excellent state universities, although private universities dominate the Ivy League category. The competition for students is intense. Institutional salaries, levels of endowment and annual budgets are simply beyond the grasp of a New Zealand government-owned institution.

Similarly, New Zealand cannot hope to match the depth and quality of the US market for higher technology learning and products.

In general, firms that need to be close to the very best higher education institutions in the world will probably not locate in New Zealand. Nor will firms that need to be close to the world's biggest consumer markets.

This is not a counsel of despair about the quality of education that local institutions can provide. It is not even grounds for pessimism. One reason why our small size and relative lack of resources do not provide grounds for pessimism is that firms and students want value for money at a quality that they can afford. Most Americans settle for less than an Ivy League school. The challenge for New Zealand tertiary institutions is to provide value for money for the range of qualities of tuition and expertise that students and firms require. There would be no shame or dishonour in providing a sound education for the mass of New Zealanders at a cost that represents real value for money. However, to say this is to beg the question. Impediments to providing value for money in New Zealand education are discussed below.

The challenge for local educational institutions is to find efficient ways of avoiding being bypassed by firms and students. New Zealand students who have the ability to benefit from the world's most excellent institutions can go to them, just as many Americans have to travel to get into an Ivy League school. Similarly, New Zealand firms that want to tap into the top minds in any discipline can approach those people directly, wherever they are located.

Local providers of tertiary education can assist New Zealand firms and students to tap into offshore centres of excellence in many ways. These include ownership, franchise or accrediting arrangements, joint ventures, exchange programmes, radio, video, television, teleconferencing, two-way correspondence via email, the post or the internet, educational compact disks, written materials and so on.

This point is timely because new communication technologies are sharply reducing the costs of transporting information globally. Furthermore, increasing global competition will surely force an increasing number of providers of tertiary education to consider supplying goods and services to customers in other countries.

But these are not the only considerations. If we continue on the path set in recent years, the average New Zealander who remains in New Zealand will continue to get poorer compared with their counterpart in countries with better performing economies. This, and an ageing population will intensify budgetary pressures on the government. The drive to get better value from the public's money is bound to intensify. Educational spending will not escape scrutiny. The confused basis for many current government policies for education makes the sector vulnerable to political risks.

Currently, for example, there appears to be no consensus as to whether state support for tertiary education is intended to be in the interests of the students or of local providers. If funding is for the benefit of the student it is only logical that the student be permitted to spend it on the course that provides the best value for money. Forcing the student to spend it locally is unlikely to be in the student's best interests.

Another obvious benefit from allowing funding to be neutral across the national border is that it would increase the competitive pressures on local providers. It is competition that empowers users and obliges providers to supply value for money.

Of course the same argument for more neutral funding also applies locally between private tertiary educational institutions and state-owned or -controlled tertiary educational institutions. Pressures for more neutral funding can only be expected to become more intense as competition intensifies and student dissatisfaction with the quality of some courses grows.

Comparative advantage

What clusters of excellence could develop in New Zealand between firms and educational institutions? This is difficult to predict because it often depends on the chance that sees individuals of outstanding talent in the right place at the right time seize an opportunity that may have seemed purely a dream to others. Many people would once have put the likelihood that New Zealanders could win the America's Cup into the dream category. Yet becoming a sustained centre for excellence in related industries is now within the realms of possibility.

However, some things can be said about New Zealand's comparative advantage and the presence or absence of clusters. For the sake of brevity, I will focus on one possibility – the development of stronger clusters of excellence in relation to pastoral production.

First, centres of excellence in other countries are an opportunity, in relation to New Zealanders' standard of living, not a threat. We should not be concerned if the United States is mostly better than us across-the-board. The theory of comparative advantage in international trade explains why. Centres of excellence in another country should lift living standards everywhere. As long as New Zealand is open to trade we can derive much the same benefits from technological advantages in the United States, or elsewhere, as consumers or user firms in the United States itself.

There are so many misconceptions in lay thinking about comparative advantage that it may be worth pausing to comment on some of them.

First, our daily media often recycle uncritically the misconceived view that New Zealanders cannot have a high standard of living if our economy is dominated by the production of raw materials or basic commodities. Many well-educated people, including some scientists, take this as self-evident. They believe that unless the government increases spending on the information society, New Zealand will be left behind.

However, it is wrong to think that high standards of living cannot be achieved from the sale of basic commodities. New Zealanders enjoyed one of the highest average standards of living in the world 50 years ago from doing just that. More recently, McDonald's and Starbucks created many jobs and achieved massive wealth gains for their shareholders from selling basic commodities – hamburgers and coffee.

A related misconception is that we cannot have a high standard of living if we specialise in producing products whose relative prices are falling. Those people promoting this fallacy may cite meat and wool as examples. The same people often advocate greater government funding of information and technology. But by the same argument, shareholders in Intel and Microsoft could not hope to make money because silicon chips and software prices keep falling far faster than meat and wool prices. Quality adjusted, the price reductions in the computing and communications fields have been phenomenal.

The source of these fallacious ideas is not hard to find. They confuse price and productivity. What counts for our standard of living is the margin between price and cost multiplied by the quantity we produce. A sustained fall in the relative price of foodstuffs in world markets tells us only that there are sustained gains in relative productivity in agriculture. The dramatic falls in the price of an Intel chip tell us that the productivity gains in silicon chips are vast.

A related but equally questionable anti-agriculture assumption that is sometimes expressed by government officials and government scientists is that we cannot participate in a knowledge-based economy if our standard of living is based on producing mountains of animal protein and animal and wood fibre. One despairs about the lack of imagination behind such a view. Einstein looked at a lump of coal and imagined that the energy in its nucleus could provide fuel for a whole city. Creativity and science have turned sand into glass, and created cement and the silicon chip. Food technologists have turned the protein and fat that is milk into a large range of products and uses. There are no known limits to what future uses human resourcefulness and creativity might be able to find for mountains of raw material in the form of fat and protein.

To say all this is not to make a judgment about whether the New Zealand government should be spending more or less on land-based research. To the contrary, the point is that New Zealand governments do not have a sound basis for judging what future breakthroughs might occur. Nor do they or their officials have a good incentive to get these judgments right. In this politicised and bureaucratic world, misconceptions can have an undue influence because a plausible argument can be more persuasive than a correct argument.

There seems to me to be no reason why New Zealanders should feel that any comparative advantage we enjoy in land-based and sea-based production conflicts with the likelihood of developing a knowledge-based society.

I do not wish to argue that we are getting it right at present. To the contrary, Michael Porter's work on New Zealand (the Porter Study) provided a compelling case that we are not getting the clusters of excellence in agriculture that we should be getting. The case is based in part on barriers to the testing of competing ideas and products. New Zealand's statutory producer board monopolies and the government's near-monopoly in the funding and ownership of science and education impede those testing processes.

The following examples illustrate this point.

If a government scientist or researcher did make a breakthrough, could they patent it for their own benefit, become very wealthy and plough the money back into their research institute? Hardly.

If an entrepreneur believed that a monopoly board was failing to develop the right products for an export market and the right exporting strategy, could the entrepreneur get into the market and prove the point? Absolutely not if they needed New Zealand product.

If a farmer could not convince a monopoly board that a new product had a great future in world markets, what could the farmer do about it? Virtually nothing.

Can producer boards that have to be geared to handling a bulk commodity also develop an entrepreneurial culture based on excellence in developing niche products and markets? Politely put, this is a 'big ask'.

Can producer boards handling a seasonal locally produced product also find the capital to smooth annual production by buying and processing the product of other countries in the off-seasons? Probably not. Cooperative structures have their comparative advantages, but tapping into capital markets is not one of them.

Given all these problems, why do we have monopoly producer boards? The most common reason – the weak selling argument – is simply another widely held fallacy.

The following version of the fallacy suffices to fool the news media and the public most of the time. It is said that, if there are two exporters trying to sell into the one market then the second exporter will undercut the first so that both lose compared with the single seller case. For example, according to the argument, a second seller trying to put 10 cases of apples into a market will be undercut by an independent exporter trying to put another 10 cases into the same market.

But no Stage One economics student would be taught that consumers will pay more for 20 cases of apples if they are supplied by two exporters each supplying 10 cases than if they are supplied by one monopoly board supplying 20 cases alone. An apple is an apple. Consumers only buy more apples of a given quality if the price is lower. Consumer demand depends on the number of cases offered – not the number of sellers.

Lay people may fall for the argument because it invites them to confuse a reduction in the number of suppliers with a reduction in the quantity supplied. But the only way suppliers can increase price is by reducing the quantity supplied into the market. The only clear-cut way a single seller might hope to get a higher price would be to persuade farmers to produce a smaller number of cases than in the multiple seller case. Even then, the single seller argument would have to include a convincing case that other countries would not simply step up their own production to fill the gap. This is not a challenge I recall seeing any reputable economists take up, at least as a general proposition. But even this possibility is academic because it would require systems for reducing production from New Zealand farmers. As it happens in New Zealand some producer boards do the opposite. They are more or less obliged to take everything that is produced. Moreover, bundled payout structures seem guaranteed to cause over-production. This is ironical. A form of the single seller argument that only makes sense if the single seller can reduce farm production relative to the multiple seller case has been used for decades to support a structure that seems guaranteed to do the opposite.

There are more sophisticated arguments, but they do not count in the public debate. Michael Porter considered them all, but came to what I believe is the only economically defensible conclusion – monopoly structures in agriculture are an impediment to achieving higher living standards in New Zealand.

I stress that to attack the single-desk seller argument for conferring a statutory monopoly status on producer boards is not to attack the boards or cooperative arrangements or structures. They have their place for as long as their members want them. But their monolithic statutory monopoly structure undesirably impedes the development of a stronger cluster of excellence in relation to education, science and the relevant industries.

The simplest thing to do is to remove the statutory monopoly status of producer boards. This would allow entrepreneurs to compete for farmers' products. If the boards provide the superior returns for farmers that they claim to provide, they have nothing to fear.

Of course, more should be done than this if stronger clusters of excellence are to be built on our comparative advantage in agriculture. Government dominance of the ownership and funding of science is inevitably associated with multiple, conflicting objectives that can only be traded off through political and bureaucratic processes. Incentives are weak and confused. The strongest incentive of bureaucracies is to build and protect institutional empires and capture funding mechanisms.

Another widespread fallacy is that New Zealand Incorporated will become uncompetitive if our universities do not enjoy the highest rankings or if New Zealand firms do not register patents or spend on research and development (R & D) at the same rate as US firms.

However, the theory of comparative advantage demonstrates why countries are competitive in trade through adjustments to the rate of exchange, regardless of differences in levels of productivity. It is no more valid to fear that the wealthy nations cannot compete with the poor whose labour is so cheap than it is to fear that the poorer nations cannot compete with the rich because of all the latter's technology, skill and infrastructure. Firms in poor countries compete with firms in rich countries to the benefit of all consumers.

What determines our standard of living, as New Zealanders, is our productivity, not the country of origin of R & D or the country of residence of Nobel laureates. New Zealand firms that want to access foreign R & D have many ways of doing so. One option is to sell themselves to a foreign firm that undertakes that R & D. The prosperity of New Zealanders does not depend on who owns New Zealand firms. Value for money does not depend on the country of origin of the product or of the firm's owners. The value for money of a pair of gumboots of a given quality does not depend on whether it is made in India, China, Vietnam or New Zealand.

What does threaten our prosperity is the lack of quality in much government spending and regulation. In general, governments are probably the biggest cause of poverty in nations. Last century, for example, communism and fascism proved to be an endemic cause of poverty. More generally, excessive state ownership and control, corrupt institutions and the absence of a rule of law are guaranteed to produce poverty on a grand scale.

The flip side is that governments that stand aside sufficiently to let the creativity of their people flourish allow their citizens to achieve prosperity. Abstracting for the moment from the welfare state, the critical determinant of the budget constraint of consumers is their productivity in selling their labour. This does not depend on where firms or industries choose to locate. Nor does it depend on whether any given individual is working in a firm producing high technology or low technology goods or services. It does depend very much on the individual's skill levels, the quality of their performance and how much capital they have to work with. Better governed countries should enjoy better infra-structure, a better education and health system, and better access to foreign capital. The upshot should be greater productivity per worker of a given skill category.

In short, government policies undoubtedly affect living standards and where firms and people locate. But the standard of living in New Zealand does not depend on the location of any particular cluster.

Implications for educational institutions

New technologies and the Web have the potential to reduce radically the costs to students and employers of accessing expertise and information wherever it is located. To avoid being bypassed, local providers of tertiary education can use the same innovations to provide better value for money.

Non-educational businesses are, of course, facing exactly the same challenges and opportunities. By using the Web, any provider may be able to reduce the costs of coordinating supply. For example, suppliers from anywhere in the world might be able to tender for the provider's business using the Web on an ongoing basis. Tender documents of whatever complexity can be cheaply and instantaneously conveyed to potential bidders regardless of their location. Problems of security and payment can be solved. Similarly, the Web allows information about available products and services to be conveyed cheaply around the world. The Web will also allow businesses to get much better information about each customer's preferences. It will also allow services to be bundled in ways that discriminate much more finely between classes of customers.

Providers of tertiary education can supply their products and expertise to offshore customers through any combination of visiting lecturers or consultants, tutors or trainers, split campuses, mergers, joint ventures or franchise arrangements. For many educational purposes, tertiary institutions can be bypassed entirely as the books of the 'Do-it-yourself, Teach Yourself' and 'X for Dummies' type illustrate. Much learning can be generically packaged. Tutors operating autonomously can supply individual tuition. The Web is going to allow products to be much more individually targeted than current radio or television broadcasting systems will permit.

In so doing, local providers of tertiary education may be able to supply courses of out-standing quality in world terms despite being unable to match the quantum of resources of the world's best endowed institutions. International trade based on specialisation and comparative advantage is a wonderful thing.

Government ownership, regulation and funding of the providers of tertiary education could influence profoundly, for better or for worse, the ability of institutions to respond to the challenges. Government control of board structures may make it very difficult to resolve fundamental differences of opinion about strategic directions at board level. In privately controlled organisations, takeover mechanisms may be more feasible ways of resolving conflicts.

Governments can also be unwilling to provide risk capital for new ventures, particularly in risky new technologies or in offshore institutions. Government ownership or control may also make it difficult for an institution to sign away some of its independence by forming a joint venture with a reputable offshore institution.

Government regulation of universities and polytechnics may also inhibit flexibility. For example, some local regulations may serve the interests of non-performing staff relative to other staff or students. Other regulations may inhibit flexibility in terms of course structures or content.

In turning to funding, it can be observed that, New Zealand-located educational institutions are biased by government subsidies towards to the supply of services to students who are New Zealand residents. This is because the Equivalent Fulltime Student (EFTS) scheme subsidises such students if they patronise local, as distinct from offshore, institutions. Clearly, students who want value for money would not want to be restricted as to location. The current funding bias means local institutions face the risk that a future government will decide that the interests of local students should be put ahead of the interests of local providers. It could also make them more inward-looking than is desirable. A more neutral system could encourage local educational institutions to strengthen their links with offshore educational institutions of higher international standing. This could make them more attractive to New Zealand students who might otherwise go offshore and it might attract more offshore students to New Zealand.

Our existing subsidies arguably drive institutions to increase throughput at the expense of quality. Because students are only confronted with a small fraction of the costs of tuition, they may not pay enough attention to the quality and relevance of the courses offered. Students are also disempowered by the fact that academic staff get paid regardless of the level of student dissatisfaction. While students can complain and vote with their feet, they cannot withhold their cheque.

This is not an argument for eliminating all tuition subsidies. However, it is to argue that the government should be rigorous in insisting that subsidies are limited by the public good component of a tertiary education. Pressures from institutions and students to increase subsidies are understandable, but swollen subsidies distort institutions and put them at risk when governments run into fiscal pressures or the need to improve value for money.

Concluding remarks

New Zealanders stand to benefit greatly from cheaper access to better education (measured in terms of the cost of resources). Widespread ignorance about basic economic concepts such as comparative advantage, specialisation and the importance of competition and the price mechanism is arguably increasing political risks and is reducing living standards in New Zealand.

Governments can protect local institutions from competition by regulation, ownership and targeted subsidies. But the costs can be high and the privileges thus conferred are always at risk. The same arrangements may also frustrate institutional attempts to improve their performance and reorient themselves.

Educational institutions face an increasingly competitive environment, but there is much they can do to take advantage of it. In particular, they can get closer to the firms that hire their graduates and they can address the issue of how to help New Zealanders tap into clusters of excellence in education internationally.

THE INDUSTRIAL RELATIONS CONFERENCE
FOR 2000 WORK RELATIONS NEW ZEALAND

HARMONY AND CONFLICT
IN WORKPLACE RELATIONS

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WELLINGTON
28 FEBRUARY 2000

HARMONY AND CONFLICT IN WORKPLACE RELATIONS

Employers need workers to produce the products and to provide the services that the firm's customers require. Workers desire the wages that productive work provides. Employers and employees are a team that have a strong common interest in a commercially successful firm. The size of the cake counts.

Production is a cooperative activity. Teamwork is as critical to success in business as it is in sport. The more competitive the environment the greater the premium on cooperative teamwork within the firm and between the firm and its suppliers. Dysfunctional teams cannot be expected to survive unless the government owns them or they have a statutory monopoly.

Despite the common interest in the success of the team, conflicts will arise between team members. There will be debates and disputes about tactics, strategy, the specification and allocation of tasks and the distribution of rewards. Disputes are costly, but they can also lead to valuable changes in direction.

No firm can be expected to survive in a competitive market if it is unable to resolve disputes decisively. Where this cannot be done by mutual agreement, it must be done by managerial decision. Again, competition is the crucial element for restoring a productive level of harmony and cooperation. Competition for workers and managers allows dissenters to exit. Those who stay do so on the basis that they accept the managerial decision. Those who leave may do so to join a more congenial team.

Harmony is at risk when the dissenters reject the decision but do not exit. Team relationships can quickly become unproductive unless the disruptive members can be fired. Laws that raise the costs of firing non-performing or disruptive team members can easily prolong damaging behaviour. Every government department and university must have experienced this problem.

Clear evidence that workplace relations have become pathological exists when employees make it clear that they regard the employer as their enemy and do not care about the interests of the firm's customers. In New Zealand, Douglas Myers tells a story of brewery workers who regarded him as the enemy after he took control of what was then New Zealand Breweries. The workers regarded the members of the competing team – Dominion Breweries (DB) – as their friends. In similar vein, trade union threats in the 1950s and 1960s to 'bring the country to its knees' if their demands were not met and the frequent strikes on the Cook Strait ferries, timed to maximise disruption to the travelling public, illustrate the problems of a dysfunctional system.

Although harmony is generally thought of as a good thing, command and control regulations can easily produce situations in which harmony is seen as perverse. One recalls Muldoon's famous charge following the 1968 nil general wage order that employer groups and trade unions had formed an 'unholy alliance' to push up wages. The implication was that employers should be forced to hold down wages. This was splendidly inconsistent with the view that the labour market legislation of that time was necessary to protect labour from employer power.

Other potential indicators of pathology in labour markets include high and persistent unemployment, a high incidence of strikes, lock-outs, pickets, demarcation disputes between groups of workers, frequent appeals for ministerial intervention to resolve disputes and frequent recourse to government-mandated arbitration processes. New Zealand has had plenty of experience this century with all these manifestations of disorder. There was a time during the 1960s when it seemed as if the whole country would come to a halt without Tom Shand, the then minister of labour, personally finding a solution to every major dispute on a case-by-case basis.

The crucial cause of undesirable conflict and dysfunctional behaviour in labour markets is lack of choice. Inability to exit is one manifestation of lack of choice. So is monopoly or monopsony.

Governments confer privileges on a group when they create a statutory monopoly position for it. The classic socialist view is that employers are of a different social class from their employees and desire to exploit them by somehow creating a reserve army of unemployed and depressing wages. Karl Marx also argued that employment alienated workers from their product. Capitalism would fall as a result of its inescapable contradictions.

In contrast, history has demonstrated that capitalism produces an affluent middle class and workers' revolutions failed to materialise. The Marxist view failed to explain why an unhappy worker would not exit in order to join a better team at a more successful firm. Nor does it explain why a group of workers or a union would not set up their own firm. Even collusion amongst existing employers on an inconceivably grand scale would not suffice to stop groups of workers from forming their own firm – or emigrating. Perhaps financiers would also collude with capitalists by refusing to finance firms started by ex-workers? This would be to argue that financiers are not interested in profitable business with ex-employees. But if financiers are not interested in profits, why would they want to exploit workers in the first place?

Another fear related to market power is that an employer could depress wages by threatening to sack its entire labour force. To be credible, this argument would have to presume that either the firm was going to close or that it could replace readily its existing labour force with new workers. But the latter scenario is not evidence of market power by employers. It is simply evidence that workers compete for jobs.

In a competitive situation, wages for all are set by the cost of hiring an additional worker, whether a butcher, baker, policeman, nurse or school teacher. As a result some workers get paid more than they would be prepared to accept if necessary to retain their jobs. Some fear that, in the absence of government regulation, employers can force the wages of these inframarginal employees down after they have hired them. However, in a competitive market, employers could not be opportunistic towards these workers because another employer would hire them in that event.

Where employees have made investments with an irreversible element (for example in moving to a home close to work) there is a risk of hold-up. Employers who behave opportunistically towards their employees are unlikely to achieve the trust and cooperation necessary for good teamwork. Every employee takes heed of the treatment of just one employee. Workers who are concerned about the possibility of not getting a satisfactory return on job-specific investments will take that risk into account before committing to them. For example, they will balance the risks against the pay, the term of the contract and the level of job security.

Any balanced discussion of opportunism and hold-up problems needs to recognise that these things operate in both directions. Employers are likely to have made particularly large irreversible investments in many cases. A group of workers who can deny the employer access to non-group labour may be able to expropriate these investments.

The market power arguments arising from the potential for employers' opportunistic behaviour in respect of irreversible investments therefore do not create any obvious case that firms will, in general, be the villains rather than the victims. In the specific case in which the firm is government-owned, it seems likely to be the victim. An example of this was the power exerted by the boilermakers over the Bank of New Zealand (BNZ) when it was building its head office. Similarly, in the case of such nationalised industries as hospitals and schools, it is clear that the government has no ability to fire the entire work force and hire another one. Rather, workers might credibly hope to hold up the government given taxpayers' irreversible investment in schools and hospitals.

Despite these puzzles, the dominant view driving government regulation of labour markets this century has been that employers would have undue bargaining power over workers in the absence of labour market legislation of a command and control nature. The current Labour/Alliance government appears to epitomise that view. It clearly desires to redress the supposed 'imbalance' between the bargaining power of employers and employees. Given that employers have no ability to stop an actual or potential employee from taking a better job offer from someone else, what does this mean?

The answer in reality is that the government will legislate to reduce opportunities for exit by individual employees or employers.

To impose a universal minimum wage is to deny an employee the opportunity to leave one employer in order to take a another job at a wage below the minimum but which offers better on-the-job training or promotional prospects.

To impose minimum terms and conditions deprives the employee of the ability to earn an even higher wage in return for a departure from those conditions. For example, some employees may prefer higher wages in return for riskier conditions.

To force employers to allocate part of the cost of labour to accident compensation payments is to deny the employee the opportunity to receive the same sum as a wage that could be used for something else. For example, most employees would surely prefer to purchase insurance against loss of earnings from accident or sickness.

All such command and control legislation reduces the range of options available to employers and employees. Denying dissidents the freedom to contract for options that suit them better removes their option to exit. This can aggravate disunity and impair welfare. The benefits are usually factional. Minimum wages, for example, obviously put the interests of those with jobs ahead of those without jobs.

Legislation designed specifically to create privileges for trade unions brings an additional dimension to the analysis. A trade union has an incentive to create monopoly profits in the form of excess wages and perks for itself and its members. To do so it has to be able to stop non-members from competing with members for jobs. It is unions, not employers, who have an obvious interest in maintaining high unemployment through high minimum wages or generous unemployment benefits.

The details of what the government will propose with regard to workplace relations are not yet known. According to a recent, not unsympathetic, advertisement in *The Independent* by Brooker's Limited, the proposed changes to the Employment Contracts Act 1991 (ECA) will return unions "to their position of yore as indispensable to the collective bargaining process", apparently regardless of performance. The advertisement asserts that the legislation to create privileges for unions is being drafted with the help of the Council for Trade Unions. This is an extraordinary assertion given that the government is making a virtue of opposing alleged monopolies in network industries. However, the same government's commitment to increase the scope of the state monopoly of accident insurance is also perplexing in this context.

Brooker's Limited also report that the level of additional disputation expected as a result of the proposed changes to the ECA could double the Employment Court's workload. In the absence of details of the proposed changes we shall just have to wait and see. However, the Court's workload is already bloated by the provision in the ECA that stops employers and employees from contracting out of the Act's personal grievance provisions.

Laws that establish a statutory monopoly create risks of hold-up. As already discussed, firms or skilled workers that have sunk investments may have any economic rents they hoped to enjoy expropriated by hold-up subsequent to those investments. By definition, unskilled workers are not as exposed to such risks, although this is not to say they are immune.

Trade unions have an incentive to try to inhibit competition for jobs from non-members. Those who are unemployed are obviously at risk, but so may be non-union workers. The recent tragic picketing case in Lyttleton, Christchurch which resulted in a death appears to reflect an attempt by union groups to prevent an employer from contracting out – ie offering jobs to non-members. If so, this looks like a classic case of an attempt to use force to monopolise a portion of the labour market. Proposals for legislation to stop non-members from signing contracts that are 'worse' in some dimensions from those in a collective contract would similarly have the effect of reducing the exit opportunities of employees whose preferences are not best met by the collective contract. Proposals that would make it easier for unions to achieve industry-wide collective contracts also make it harder for dissenting employees to exit from the collective contract while remaining in the industry. This could reduce the ability of dissenting employees to find employers offering contracts that would better meet their preferences.

Legislation that confers privileges on unions that operate on a majoritarian basis also raises the issue of the exploitation of a minority of workers by a majority or by powerful union officials. For example, a majority may be able to impose work practices and collective agreements that penalise workers who might want to work harder for more pay or advancement or who might be better off if remunerated on a productivity basis. Consider the Post Primary Teachers' Association (PPTA) opposition to bulk funding and performance pay.

Proposals to introduce compulsory arbitration raise the possibility that employers and employees could be deprived of the option of finding better arrangements. In conjunction with rules that raise the cost of closing down and/or firing employees if the decision goes against the firm, such a rule creates risks for investors in firms that have made sunk investments. This can be expected to raise the cost of capital for such projects. Conversely, if a compulsory arbitration favours the firm, workers who have invested heavily in firm-specific knowledge may be put at greater risk.

Proposals to make good faith bargaining mandatory promise to benefit lawyers and to raise the cost of bargaining. Unions can effectively say to a firm: "You have invested more sunk capital in this business than we have. Accept our demand or we will tie you up in court trying to defend yourself against the claim that, regardless of objective facts to the contrary, you lack good faith because you will not agree to our eminently fair proposal".

It is difficult enough for a government to legislate as to what constitutes a fair process. It is surely even more difficult to legislate for intentions. Firms are particularly at risk because they hold significant commercially sensitive information that unions may be able to threaten to force them to divulge unless they agree to give the union or its members the benefit of their sunk capital. Such legislation obviously lends itself to opportunistic hold-up by unions of firms that have made irreversible investments in New Zealand.

It is obvious why Brooker's Limited see the proposed changes as a bonanza for lawyers and for the Employment Court. But the costs must fall somewhere. Obviously they cannot be expected to fall on firms that have yet to make any irreversible investments in New Zealand. Such firms must see such a licence for opportunistic behaviour by unions as an effective increase in the cost of labour in New Zealand. Their demand for labour will be reduced accordingly unless there is a compensating fall in other components of the cost of labour, such as the real wage. For these reasons, the burden of the proposals must be expected to fall eventually on labour. Initially it can also be expected to fall, in part, on firms that have sunk capital in New Zealand.

There are clear reasons why unions may benefit in terms of membership and funding from legislation that is likely to affect investment adversely in New Zealand and the demand for New Zealand labour. It is equally clear why a Labour/Alliance government might welcome such a development. But these are not national interest reasons. To the contrary, privileges created by statute are likely to be impoverishing, divisive and ultimately counter-productive.

We can expect dissension in the labour market to be as prominent in the foreseeable future as dissension in those other state-run industries that enjoy a quasi-monopoly status – health, education and social welfare. Legislating for intentions is yet another sign of over-ambitious government action.

How serious are the likely adverse effects? This must be seen in a broad context. Governments can easily attract or deter investors through their tax, spending and regulatory policies. Because labour and taxes are major costs for businesses, what the government does with tax rates and things like accident compensation legislation and the ECA have the potential to outweigh anything else it might do to create a more positive climate for business in New Zealand.

The move back to a conflict model for industrial relations based on union privileges, regardless of performance, promises to be costly from a national perspective.

APPENDIX

Economic conditions in New Zealand include some positives but also a large number of negatives for New Zealand businesses and for workplace relations.

Positive features of the current economic scene include:

- resumed economic growth and relatively high levels of business and consumer confidence;
- sustained low inflation and much reduced net public debt this decade;
- strong economic growth in some major trading partners and clear evidence of economic recovery in some Asian countries;
- New Zealand's high international position in many important indicators of economic prosperity including the absence of corruption and the security of the rule of law;
- New Zealand's participation in the general move to lower trade barriers, therefore forcing local businesses to compete harder for the consumers' dollar; and
- the potential for major reductions in costs as a result of advances in telecommunications, computing and the Internet.

Obviously, some of these features provide challenges for businesses. But if businesses are not challenged, New Zealand will never prosper.

More troubling features of the economic environment in recent years include:

- our loss of economic vigour since the end of the upturn that commenced in 1991;
- the major cumulative increases in government spending since 1993, and the concomitant increases in the total tax burden;
- the poor quality of much government spending, reflecting an inability to determine where the government has a comparative advantage relative to businesses, households and the non-profit sector, and confusion about how to trade off conflicting objectives;
- the undermining of the public sector as over-ambitious government programmes inevitably disappoint and frustrate public opinion and politicians exploit the politics of envy in order to make scapegoats of senior office holders;
- the growing economic weaknesses reflected in the reversal in recent years of the strengthening trend in New Zealand's sovereign credit rating;
- persistent high unemployment, broken families and welfare dependency;
- persistent evidence of mediocrity in our education system;
- evidence of net emigration of young professionals;
- evidence of reducing entrepreneurial interest in New Zealand amongst top local businesspeople and offshore investors;
- the ever-increasing regulation of businesses in respect of taxes, privacy, human rights, consumer protection, hiring and firing, securities regulation, competition policy, safety and the environment, including heritage sites. It is no longer credible to assume that small businesses can knowingly comply with all the regulations that potentially apply to them;
- the tolerance of continuing high levels of unemployment that is reflected in successive governments' acceptance of the progressive regulation of the labour market as a result of Employment Court rulings and the implementation of a minimum wage for youth;

- the exploitation of the politics of envy towards big business, epitomised by the invasion of individual privacy in respect of top private sector remuneration that results in individuals being vilified by the ignorant;
- the preference of governments for statutory monopolies in the provision of private goods in such major areas as agriculture, education, health and accident compensation, partly as a result of the failure of voters to recognise the importance of competition;
- the faltering of the programme of government asset sales and its current demise; and
- the mediocrity and political paralysis in government that seems to be endemic in the Mixed Member Proportional (MMP) electoral system.

This list is daunting and looks set to get worse during the next few years. In recent months the new Labour/Alliance government seems to be signalling that it believes a host of actual and perceived problems can be alleviated by even more spending or regulation and government ownership. The criteria used to decide what limits should be put on government are unclear.

In the event that the high spending, command and control view of government prevails, New Zealand's future seems likely to resemble that of Tasmania.

DUBLIN ECONOMIC WORKSHOP

SUCCESSES AND FAILURES OF LABOUR MARKET REFORM IN NEW ZEALAND

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DUBLIN
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SUCCESSES AND FAILURES OF LABOUR MARKET REFORM IN NEW ZEALAND

Background

For most of the past 100 years, New Zealand has had a heavily regulated and centralised labour market system. A 1894 statute aimed at avoiding strikes introduced a compulsory arbitration system whereby disputes not resolved by negotiation were to be resolved by a central arbitration court. It also provided for extended agreements covering many employers in a region or industry, including employers who were not parties to the original dispute. Over time, a British-style craft-based trade union structure developed, including registration of unions and, from 1936, compulsory union membership. New Zealand was a flourishing country around the turn of the century and its system attracted international attention. Features of it were adopted in Australia, the Weimar Republic in Germany and the United States during the New Deal era.

In the decades that followed, a regulated labour market evolved hand-in-hand with a protected economy and regulations that governed many economic activities, including frequent episodes of price controls. Centralised forms of wage restraint were often seen as necessary to check inflationary pressures arising in the cost-plus environment. Tripartite structures involving employers, unions and the government became a feature of economic policy making. In the immediate post-war period the leader of the trade union movement actually had an office in the Treasury as a member of an economic stabilisation commission.[1]

By the early 1960s it was becoming clear that decades of controls and inward-looking policies were taking a toll on New Zealand's economic performance. For the next 25 years, however, attempts to grapple with the problems were fitful and ineffective. Economic difficulties intensified with the oil shocks and inflation of the 1970s and the wage-fixing system, as well as 'fortress New Zealand' policies more generally, came under increasing pressure. Various forms of incomes policies and wage–tax trade-offs were tried in an effort to shore up the rickety structures. Centralised wage orders by the Arbitration Court ceased in 1979, and voluntary unionism was introduced in 1983 but it only lasted for a brief period. For the most part the system of registered unions and blanket coverage awards remained intact.

With the election of a Labour government in 1984 against a background of economic crisis, including a serious run on the currency, New Zealand embarked on a broadly based programme of economic liberalisation. Progressively this included the removal of all wage, interest and other price controls, the dismantling of import licensing and tariffs, the deregulation of financial markets and exchange controls and the adoption of a freely floating currency, a disinflationary monetary policy, extensive product market deregulation, moves to corporatise and privatise state trading enterprises, and other public sector reforms. In most respects these were moves in the direction of policies that more successful Organisation for Economic Cooperation and Development (OECD) countries had long practised or were also implementing.[2]

The Labour government, however, found it difficult to apply a similar liberalising philosophy to labour markets. It abolished compulsory arbitration but reintroduced compulsory unionism in 1985. In that year a wage freeze ended in an environment where

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1. Michael Bassett (1998) *The State in New Zealand 1840–1984: Socialism Without Doctrines*?, Auckland University Press, Auckland, p 226.
2. For an account of New Zealand's economic reform programme, see Lewis Evans, Arthur Grimes and Bryce Wilkinson with David Teece, 'Economic Reform in New Zealand 1984–95: The Pursuit of Efficiency', *Journal of Economic Literature* Vol XXXIV, December 1996, pp 1856–1902.

disinflationary policies and increased competition had not fully taken hold, with the result that average private sector wages increased in a 12-month period by around 18 percent (and public sector wages by an even higher amount). This real wage shock was a major factor in the steep increase in unemployment in the late 1980s. Between 1987 and 1990 the Labour government made some further changes to labour market structures including the introduction of limited contestability among unions for groups of members and limited provisions for initiating enterprise-specific negotiations. These reforms were minor and piecemeal, however. They failed to meet the needs of firms that were having to adjust to new competition and they did little to facilitate the reallocation of labour from declining to expanding sectors. More significant and successful changes were made to public sector employment arrangements, to waterfront employment and to shop trading hours, which were substantially liberalised. However, not until the Labour government lost office and a National Party government was elected in 1990 did labour market reform get addressed in a somewhat more coherent fashion.

Ideas about labour market regulation

From the 1890s on, New Zealand labour law had been based on the premise that labour markets were somehow special. The driving ideas were those of Fabian socialism and were entrenched in the rhetoric of trade unions.

"Labour is not a commodity" was one slogan that dates from this era. The Clayton Act (1914) in the United States proclaimed "That the labour of a human being is not a commodity or article of commerce". An associated idea was that "wages should be taken out of competition". But while people are not commodities or articles of commerce, the labour services they provide using their mental and physical capacities most certainly are. Workers are sellers of labour services and employers are buyers. There is a supply, a demand and a price for every kind of labour. If the terms on which labour services are bought and sold are not set by voluntary contracts in competitive labour markets, there will be enormous problems achieving coordination through regulatory or judicial processes. Ironically, the one-size-fits-all uniform terms that inevitably result in a regulated environment come much closer to treating workers like commodities.

Another longstanding idea behind labour market regulation, unionisation and collective bargaining was the notion of 'unequal bargaining power' with its connotations of worker 'exploitation'. This simply misunderstands the nature of markets and competition. An individual customer at a large department store or a bank is not at risk of exploitation even if they have no apparent ability to influence the terms of their transactions. Their basic protection is actual or potential competition from other firms eager to meet their needs. Similarly, in competitive labour markets firms compete with one another for the services of employees, and wages and other conditions of employment are set through voluntary exchanges that yield mutual gains.[3] On each side, bargaining power depends on alternatives, and at times labour markets, like any others, may favour buyers or sellers. But there is no systematic or long-run bias in labour markets in favour of employers – which party has the most bargaining power in the technology industries in the United States today? Moreover, relatively inexperienced or under-educated workers are protected by the pattern of conditions established by better informed participants.

Whether theories of unequal bargaining power hold is easily tested by empirical observation. If they did, employers would clearly exploit this power and bid wages ever

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[3] This argument is explained in one textbook as follows: "Often it is said that individually employees lack sufficient bargaining power . . . . This is the argument used in favor of collective bargaining . . . . But . . . employers compete against other employers, and employees against other employees – not employees against employers, as folklore says. It is the availability of higher-valued alternatives, not the ability to bargain collectively, that increases bargaining power." Armen Alchian and William R Allen (1983) *Exchange & Production: Competition, Coordination and Control*, Wadsworth Publishing Company, Belmont, p 328.

lower. The reality, of course, is that wages and other conditions of employment have risen over time, even (or especially) in economies such as Hong Kong where labour regulations and unionisation are minimal.[4]

In the 1980s in New Zealand there was an increasing realisation that labour markets are not in fact special. Problems of 'market failure' such as public goods, externalities and monopoly are not serious in labour markets, at least in the absence of statutory interventions. By contrast, the problems associated with regulation and 'government failure' are acute, because no central authority can possibly have the information or ability to understand the needs and preferences of diverse workplaces and huge numbers of workers, and to regulate their employment arrangements in an efficient manner.[5] The conclusion reached in New Zealand by many business and employer organisations, government officials and the government that was elected in December 1990 was that employment relationships should, by and large, be regulated by ordinary contract law.

The Employment Contracts Act 1991

The long title of the Employment Contracts Act (ECA) enacted in May 1991 stated that its intention was to promote an efficient labour market. Essentially the ECA deregulated employment contracting and removed most of the structures that upheld the previous centralised system. Compulsory unionism was replaced by freedom of association, enabling employees to choose whether or not to join an 'employee organisation'. The words 'trade union' do not appear in the ECA; unions have no special statutory backing or privileges but can acquire legal status as voluntary societies or through other forms of incorporation. There is no bias either for or against collective bargaining in the ECA; section 1 (c) provides that it is a purpose of the ECA:

> To enable each employee to choose either – (i) To negotiate an individual employment contract with his or her employer; or (ii) To be bound by a collective employment contract to which his or her employer is a party.

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4 Richard Epstein has illustrated this point in the following terms: "The argument about exploitation is surely no stronger when cast in the analogous language of inequality of bargaining power. Thus assume that an employer could "dictate" the terms of trade in the marketplace. What would we expect to see the contract look like? The answer is that the employer would never stop pressing her advantage. If it turned out that the employer could dictate terms, why would she offer a wage of 10 if she could drive it down to 9; and why would she settle for 9 if she could drive it down to 8? The logic of dictation leaves the employer no reason to stop until, without mercy, she has extracted the last bit of advantage. When the process comes to a halt, we should observe people working for employers at a zero wage, and we don't. If firms can exploit workers, then retailers can exploit their customers, so that it is unnecessary to offer cash discounts, free exchange privileges, and volume discounts. Start with these oft-repeated assumptions, and there is no stable or discernible equilibrium with wages or, for that matter, prices in any relevant market. Yet the theory of exploitation notwithstanding, we have long observed positive wages for labor and finite prices for goods. . . . The idea of inequality of bargaining power, the idea of dictation, fails the most decisive test: it has no *descriptive* power." Richard Epstein (1995) *Simple Rules for a Complex World*, Harvard University Press, Cambridge, p 84.

5 "The genius of labour markets – whether in the United States, New Zealand or anywhere else – lies in the decentralisation of employment decisions. [There are] enormous odds against successful labour market outcomes created by a centralised labour statute. We are not talking here about [network industries] where there are genuine problems over interconnection that are not obviously resolved by the market. Nor are we talking about collusion amongst firms, or a business using force or fraud. We are talking about employment relations in general – ordinary contracts between employers and employees – where markets have their strongest and most vital application. There is no area in which there is a stronger case for markets." Richard Epstein (1999) *Age Discrimination and Employment Law*, New Zealand Business Roundtable, Wellington, pp 24–25.

In negotiating employment contracts, employees can freely choose their own bargaining agent – themselves, a union or any other agent such as a lawyer. Strikes and lockouts are permitted but only if they relate to the negotiation of an expired or new collective contract for the employees concerned (or on health or safety grounds). Sanctity of contract was thereby restored in these respects.

Thus far it is clear that the ECA went a long way to deregulating the *process* fully of employment contracting and introducing standard principles of freedom of association and contract. One questionable exception is that it does not permit union-only or union-free workplace contracts.

On the other hand, the ECA retained a number of provisions that regulate the *content* of employment contracts and thus treat them differently from normal contract law, and in some respects the ECA introduced new forms of regulation. These restrictions remain problematical in New Zealand labour law.

One mandatory aspect of the content of employment contracts is the personal grievance provisions of the ECA. These are particularly important in the case of so-called unjustifiable dismissals, and include both procedural and substantive elements. It is not possible to contract out of these provisions, which in effect require employers to show 'just cause' for dismissals. As a result, employment at will (the ability of an employer to dismiss without showing cause, matching an employee's ability to quit at will) was abolished in New Zealand. Prior to the ECA, non-union workers on individual contracts, who accounted for a significant proportion of the workforce, could be employed on an at-will basis.[6]

In addition, the ECA did not give the task of administering a regime based on contract law to the general courts but retained separate institutions in the form of a low-level Employment Tribunal and an Employment Court. The latter in particular has been reluctant to abide by contract law principles and has maintained a pattern of third-party interference in employment relations.[7]

New Zealand has also maintained a statutory minimum wage, currently set at a proportion of average wages that is around the middle of the OECD range. It was extended to youth wages in 1994, and is likely to be a factor in keeping youth unemployment at relatively high levels. New Zealand has not applied a contractual approach to holiday entitlements,

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6 Indeed, prior to 1970, most employment in New Zealand, including employment covered by collective bargaining contracts, was subject to the English common law under modified at-will terms. Reasonable notice of termination was an implied term. This was confirmed in the leading British case of *Addis v Gramophone Co Ltd* [1909] AC 488. As two commentators on the ECA put it, "The inclusion of all employees in the [Employment Contracts Act's] jurisdiction constitutes a remarkable extension of the state's industrial relations role". Pat Walsh and Peter Brosnan in Jonathan Boston, Paul Dalziel and Susan St John (eds) (1999) *Redesigning the Welfare State in New Zealand: Problems, Policies, Prospects*, Oxford University Press, Auckland, p 121.

7 See Colin Howard (1996) *Interpretation of the Employment Contracts Act 1991*, New Zealand Business Roundtable and New Zealand Employers Federation, Wellington. In 1997, the minister of labour, Max Bradford, stated that "There are signs the combined effect of the Employment Tribunal and the Employment Court decisions – as well as business practices flowing from those decisions – may be adversely affecting employment prospects and flexibility in our labour market. Some Employment Court decisions are clearly inconsistent with the principles of the Act and have caused considerable debate over the role of the Court". Hon Max Bradford, 'What Happens Now?', Labour – Management Government Relations Seminar, Industrial Relations Centre, Victoria University of Wellington, 20 March, 1997.

which remain governed by statute.[8] Similarly, it has a mandatory approach to workers' compensation for injury from accident, although from July 1999 the private insurance sector has been able to provide accident insurance. Health and safety arrangements are governed by regulation, rather than contract, and in the 1990s other employment-related legislation introduced by governments includes a Privacy Act 1993 and legislation prohibiting discrimination on the basis of age and other grounds. Professional occupational regulation has remained largely untouched.

Thus while New Zealand, together with the United Kingdom, has moved further than other OECD countries in recent years to liberalise its labour market arrangements, it retains many restrictions that in some cases are more stringent than those in a number of OECD countries and that have little justification in terms of public policy criteria.

Experience under the ECA

The ECA is only one element, although an important one, in a wide-ranging set of moves in New Zealand over the last 15 years towards greater economic freedom, and, in some respects, it is not easy to disentangle its influence from other influences on the economy's performance. The interpretation of some of its effects remains controversial. Moreover, while a broadly sound and consistent economic policy framework was established in the early 1990s and contributed to a strong economic performance in the first half of the decade, that framework has become substantially weaker in recent years with the result that economic performance has been mediocre at best.

In looking at experience under the ECA, the first striking result to note is the virtual disappearance of multi-employer contracts. The evidence suggests that in a freer environment most employers want to deal directly with their own workforces and vice-versa. Trust and cooperation have largely supplanted former adversarial relationships. There have been substantial gains in the operating performance of many firms with the elimination of inefficient work practices, demarcation arrangements and penalty and overtime pay, and their replacement by performance elements in remuneration, flexible work practices and multi-skilling. The ECA has given employers and employees the opportunity to develop employment conditions appropriate to their circumstances.

Unions have survived and continue to be the predominant bargaining agent for the workers who opt for collective contracts. Union density has fallen from around 50 percent of the workforce to under 20 percent and only 19 percent of workplaces have any union members at all. This trend was already occurring prior to the ECA but was accelerated by its introduction.

Industrial disruption has fallen dramatically. In the five years before the ECA, annual work days lost through strikes averaged 266 000. In 1998, the figure had dropped to 11 778 – the lowest in 64 years. In the March 1999 year, 73 percent of all employees involved in stoppages were in the education sector – unionisation, national awards and other features of the old system have remained more entrenched in the public sector.

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8 Charles Baird has commented as follows: "Mandated holidays, in the form of minimum vacation periods, mandated family leave and the like, amount to an assertion by regulators (i) that they know better than individual workers and employers what holiday policy should be, and (ii) that a uniform holiday policy, imposed by central planners, is correct for all workers and all employers notwithstanding the local circumstances of time and place. . . . It is not difficult to imagine circumstances under which both workers and their employers would be better off *as they see it* if they were free to make trade-offs between holiday time and wages and salaries. There is no reason to think that voluntary exchange would result in a uniform holiday policy for all workers within a firm, much less that it would result in a uniform holiday policy among firms". Speech to the 'Moving Forward' conference on the Employment Contracts Act 1991, Auckland, 15 May, 1996.

Contrary to the views of those who subscribe to theories of unequal bargaining power, average real wages fell only marginally in the freer environment despite the recession of the early 1990s, and began to rise as the economy grew strongly in the mid 1990s. And, contrary to other predictions (sometimes by the same people), wages did not 'blow out' as labour markets began to tighten. Wage growth has outstripped inflation but has suffered from the recent decline in overall economic performance. There has been some increase in wage dispersion.

Since 1991, over 270 000 new jobs have been created, in a labour force that now stands at 1.74 million. There has been substantial growth in full-time employment and no evidence of an increase in the proportion of workers employed on a casual or part-time basis. Unemployment fell from 11 percent of the labour force in 1991 to 6 percent by late 1996, a very sharp fall by international standards, despite substantial inward migration during the period. The direct and indirect effects of the ECA clearly played a part in the improved employment trends. The unemployment rate has subsequently risen again to 7 percent in the recent economic downturn.

There has been controversy about the impact of the ECA on productivity growth. The evidence seems to indicate that aggregate labour productivity improvements have been modest, which is not surprising given the movement of many previously unemployed and low-skilled people into work. That trade-off, between job creation and labour productivity growth, would probably strike most people as a perfectly acceptable one. Recent research suggests that improvements in total factor productivity, a more useful indicator, have been significant and have been aided by the labour market reforms.[9]

Much academic opinion about the ECA and assessments by organisations such as the OECD and the International Monetary Fund (IMF) have been strongly positive. Opinion surveys suggest that most people think it has been good for the economy and that most people are happy with their own working conditions, although opinion is divided over whether workers overall have benefited. The ECA has given New Zealand an important competitive advantage in attracting business and investment, particularly vis-à-vis Australia. However, this competitive edge has recently eroded with the weaker policy environment in New Zealand and parallel moves in Australia away from centralised wage agreements towards enterprise contracts.

Other influences on labour market performance in New Zealand

New Zealand's former centralised wage-fixing system and protected economy placed a low premium on education and training and skill differentials were compressed. Many people were employed in inefficient manufacturing industries, over-staffed government organisations such as the railways and the post office, and meat processing plants serving the guaranteed UK market. Jobs were readily available for people leaving school so there was little incentive to acquire advanced qualifications.

With the opening up of the economy to international competition and reforms in the public sector, many of these jobs were lost and skill requirements changed radically. Participation in tertiary education has increased substantially and firms are undertaking much more industry training. The ECA has helped achieve the necessary wage differentials to attract and retain staff, although differentials in the lower wage ranges remain distorted by statutory minima. Nevertheless, education and training lag economic changes and there is still a substantial proportion of the total population that is poorly educated and without formal qualifications. Educational achievement continues to be handicapped by the quasi-government monopoly of schooling and higher education and by a lack of rigorous curriculum content and assessment in schools.

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9 Erwin Diewert and Denis Lawrence (1999) *Measuring New Zealand's Productivity*, Treasury Working Paper 99/5, Wellington.

Labour market trends have also been affected by developments in social welfare policies since the 1960s. Less than 2 percent of the working-age population was dependent on benefits in 1960 compared with 5 percent in 1980 and around 15 percent in the 1990s. Despite better average economic performance in the 1990s, the dependency ratio remains at 13 percent. While wider social and economic developments (such as marriage breakdown, failures within the educational system and economic adjustment) contributed to the growth in unemployment and welfare dependency, there can be little doubt that factors such as wider access to benefits and the level of benefits relative to wages – the replacement ratio – have played a key role. A new domestic purposes (solo parent) benefit was introduced in the 1970s and replacement ratios increased substantially in the early 1980s. For example, the maximum unemployment benefit payable to single adults increased from about 36 percent of the average ordinary time wage (both net of tax) in 1980 to 42 percent in 1985. These changes largely reflected movements in real wages and taxes as benefits have generally been adjusted for changes in consumer inflation.

There has been a gradual recognition that welfare arrangements are unduly discouraging employment and encouraging socially harmful behaviour. Some measures designed to address the problem have been taken. Benefits were reduced by an average of 14 percent in real terms from April 1992. The rates of unemployment and domestic purposes benefits were reduced by more than the invalids benefit. Supplementary welfare assistance, such as accommodation subsidies, has increased since 1992, thereby softening the reduction for some beneficiaries. Work tests and measures designed to place people in training or jobs have been introduced or extended and the income test has been relaxed to make part-time work more attractive to beneficiaries. However, New Zealand's welfare arrangements remain more generous and costly relative to gross domestic product (GDP) than Australia's and, not surprisingly, New Zealand has a higher rate of welfare dependency.[10]

There has been concern that abatement arrangements trap beneficiaries in poverty. Until 1996 an unemployed person could receive the maximum benefit and earn NZ$50 (or $60 for beneficiaries with dependent children) a week before the benefit was abated. The abatement rate was 30 cents in the dollar up to $80 of additional income and 70 cents thereafter. Under current arrangements an unemployed person can earn an income of $80 a week before the benefit is abated. The present abatement rate is 70 cents for every additional dollar earned. These changes encouraged part-time work by beneficiaries as intended. However, full-time, full-year work is required to reduce poverty and welfare dependence.

New Zealand has not moved far in the direction of the United States to require reciprocal obligations on the part of beneficiaries to seek and accept work where they are able to do so and to apply time limits and asset tests on benefits. The problem of benefit abatement can only be effectively overcome by reductions in government spending and taxes that would provide more headroom to abate benefits without leading to excessive effective marginal tax rates.

The future

There is no doubt that the ECA marked a watershed in New Zealand's labour market arrangements. Only one political party, currently attracting less than 10 percent support in opinion polls, wants to return to anything like the old regime. The Labour Party and the union movement vigorously fought for the retention of compulsory unionism and national awards in 1991 but no longer defend them. Nevertheless, while they admit that their former stance is no longer credible, they continue to cling to the nostrums and many of the artifacts of the former system.

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10 For comparisons between New Zealand and Australian welfare arrangements, see James Cox (1998) *Towards Personal Independence and Prosperity: Income Support for Persons of Working Age in New Zealand*, New Zealand Business Roundtable, Wellington.

Thus the future course of labour market policy in New Zealand is unclear. The momentum of reform in general has slowed to a crawl in recent years, serious policy mistakes have been made – especially in the form of a big increase in government spending – and the country is under-performing relative to its potential. In the labour market area, court decisions, particularly in respect of unjustifiable dismissals, have re-regulated the labour market and partially undermined the benefits of the ECA.

A strong argument can be mounted for moving New Zealand's labour market regime further in the direction of contractual freedom. Employees who are capable of negotiating their own wages are perfectly capable of choosing the arrangements that best suit them in respect of such things as dismissal provisions and holidays. There is no more reason for thinking that they will end up with unfavourable terms because of alleged unequal bargaining power than for expecting wages to fall in a deregulated environment. The costs to employers of mandatory restrictions on dismissals will inevitably be shifted, at least to some extent, to employees and result in lower wages or other inferior employment conditions. Such trade-offs are best left to the parties to make in the light of their own circumstances. More broadly, a body of evidence suggests that by raising the costs and risks of terminations, employment protection rules cause firms to be more defensive about hiring and mean fewer employment opportunities for workers with poor skills and the long-term unemployed in particular.[11] By far the best protection for workers is a fully employed economy with plentiful alternative job opportunities. The introduction of restrictions on the terms on which people may make contracts renders those contracts less efficient and harms the prospects of restoring full employment.[12]

In a New Zealand context at least, further moves to place employment contracts on a firmer contract law footing would be facilitated by transferring the employment law jurisdiction to the general courts, in line with the practice in many other countries. Specialist courts are always prone to thinking their jurisdiction is somehow special. The Court of Appeal has reversed a large number of the decisions of the Employment Court – no fewer than 81 percent of appeals were upheld in 1996, for example – but this remedy is costly to all concerned. It should also be noted that even ordinary judges are prone to accepting some of the fallacious ideas that shaped earlier labour law. The president of the Court of Appeal, for example, has recently stated that the contract of employment cannot be equated with an ordinary commercial contract: "It is a special relationship under which workers and employers have mutual obligations of confidence, trust and fair dealing".[13] This completely overlooks the crucial importance of confidence, trust and fair dealing in commercial contracts in general.[14] While the removal of the specialist jurisdiction would help, legislators may have to give clearer guidance to the courts if the philosophy behind a statute such as the ECA is to be upheld.

In the short term, however, labour market policy in New Zealand may well go backwards. Unlike the Blair government in the United Kingdom, which appears to have largely accepted Mrs Thatcher's labour market reform agenda, the Labour Party in New Zealand is committed to reversing key elements of the ECA, and polls suggest it is likely to win office in next month's general election.

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[11] See John T Addison and W Stanley Siebert (1999) *Regulating Labour Markets: More Costs than Benefits*? Hobart Paper 138, Institute of Economic Affairs, London, pp 59–71.

[12] See Charles W Baird (1996) *The Employment Contracts Act and Unjustifiable Dismissal: The Economics of an Unjust Employment Tax*, New Zealand Business Roundtable and New Zealand Employers Federation, Wellington.

[13] I L M Richardson, 'Myth or Reality: Employment Cases in the Court of Appeal', speech to the Employment Law Institute, 20 August, 1999.

[14] Charles Baird has commented that "Formulations like implied term of mutual trust and confidence" and "covenant of good faith and fair dealing" are simply lawyer-talk designed to allow judges to substitute their own views on employment relationships for the views of the individual parties involved". Speech to the 'Moving Forward' conference on the Employment Contracts Act 1991, Auckland, 15 May, 1996.

Labour's election policy rejects the notion that labour services are exchanged by willing buyers and willing sellers to mutual benefit, and is based on the ideas of class domination underlying the former system:

> Legislation should also recognise that the balance of power or influence between workers and employers is not equal. Labour believes that the best way to redress this imbalance is to encourage the collective organisation of workers and to foster collective bargaining . . . .[15]

In line with this philosophy, Labour proposes to restore the role of unions, in particular by giving them the sole rights to negotiate collective contracts, impose more restrictions on the negotiation of individual contracts, allow strikes in support of multi-employer contracts (thus facilitating a return to industry awards), bring dependent contractors under employment law and introduce so-called 'good faith' bargaining that would greatly extend the scope for judicial meddling in employment contracts. Related policies would further reinforce the role of unions. These are significant incursions into the rights of workers and firms to freedom of association and contract.

Such moves would be damaging to employment prospects in New Zealand and its attractiveness as a place to work, invest and do business. They fly in the face of advice from the OECD and other commentators that the real priority should be to remedy the provisions of the ECA that have been undermined by the courts, and to take other steps to make it easier for firms and workers to contract on mutually acceptable terms. In the event that Labour's proposals are implemented, such advocates of reform will have to take comfort in the fact that governments inevitably change, and that, under a subsequent government, labour market policy in New Zealand is likely to show greater respect for freedom of contract in the labour market setting.

If the flaws in the ECA were remedied in this way it might constitute a useful model for other countries.

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[15] New Zealand Labour Party (1999) 'Working Together: Labour on Employment Relations', p 1.

SOCIAL POLICY

ARTICLE BY CATHY BUCHANAN AND PETER HARTLEY
FOR THE *NEW ZEALAND HERALD*

EQUITY AS A SOCIAL GOAL

JUNE 2000

EQUITY AS A SOCIAL GOAL

What is fair? This question has bedevilled us since childhood. When another kid got a bigger ice cream, a place on the sports team or a part in the school play, we wondered whether or not it was fair.

At first it seemed that what was equal was fair. As toddlers we wanted to be equal with other children. We wanted an equal number of pushes on the swing, an equal number of peas on our plates and an equal number of stories at bedtime.

Later, we realised that what is fair is not always what is equal. Not everyone can be captain of the sports team or the star of the school play. People have different abilities, and they should specialise in what they do best. A new definition of fairness emerged: what is fair is for people to have the opportunity to capitalise on their abilities. Rewards should be determined by merit.

As we grew older, we noticed that rewards are not always given to those who deserve them. Some are rewarded by accident, while others who should be rewarded are overlooked. Life is full of mishaps, and deciding when someone deserves something is difficult.

By the time we reached adulthood, we realised that fairness is a complex notion incorporating both what we ought to do and what we can do.

Each person has trouble deciding how to act fairly. If it is difficult for an individual to be fair, how much harder is it for a society to be fair? At the level of social or governmental action, the fallibility of human nature is magnified.

If we were philosophers, we might abandon the attempt to understand fairness or equity because the term can never be defined precisely. When we doff the beret and don the hard hat, however, we realise our need for institutions that do a good, if not perfect, job of ensuring that people are treated fairly. In short, equity is a problem that cannot be ignored.

The toddler's idea that equity involves being equal with other children is an example of what economists call 'horizontal equity', the notion that equally situated people should be treated equally. Equality before the law is an important example of horizontal equity. Our belief in horizontal equity leads us to oppose racial and other forms of discrimination.

While free markets and competition allow anyone to supply goods or services, special licences, subsidies, and other government support programmes do not treat people in the same situation equally. When we grant equally situated people privileges, we violate the principle of horizontal equity.

Many people think horizontal equity is inadequate and want to implement programmes to reduce inequality. There are, however, two different motives for wanting greater equality. The first is a compassionate concern for those in need. The second is envy of those who are well off.

A rational but risk averse person may decide that lower average living standards are acceptable in exchange for a life that is free of poverty. A concern for limiting poverty is not the same, however, as opposing opportunities for some to become very well off. Risk aversion does not justify eliminating all chances of getting ahead.

Even if complete equality were desirable, it would be unattainable because there is no objective way of measuring how well off people are. Annual money income is a poor measure of well-being. University students, for example, have a low money income but many are destined to become well-off after they graduate.

Temporary bad luck may also give people a low measured income, although they are not truly poor. Urban workers with high housing costs might be worse off than their rural counterparts, even if the former have a higher money income than the latter. In many instances, redistributing resources from higher income to lower income people would exacerbate inequalities in living standards. It is easier, however, to determine when a person is facing hardship.

Trying to achieve equality through taxation and income transfers makes some people better off but most people worse off. Taxes and transfers are costly to administer and distort incentives. The benefit of much government spending is far below the costs imposed by the taxes needed to finance it. A sacrifice in living standards is a particularly poor bargain when people receiving government handouts could look after themselves.

Attempting to equalise money incomes may even make the poorest citizens worse off. Suppose a valuable new firm were established in New Zealand. The founders of the firm might become millionaires overnight. Hundreds of new jobs would be created, and wealth would spread throughout the economy. Although income inequality would increase in New Zealand, many people would benefit and few, if any, would be made worse off. Should we block such a development in the interests of greater equality?

Envy is the only plausible reason to favour equalising money incomes. Everyone feels envious sometimes. We should put aside our feelings of envy, however, because indulging them is harmful and delivers little in return. As a German proverb says, "True equality exists only in the graveyard".

Should equity be a social goal? If equity is defined as equal treatment of equals, equality before the law, or a compassionate concern for those in genuine need, then it deserves a place among our moral beliefs and public policies. If equity is defined as equality of material wealth or equality of money income, then it should be rejected both because it lacks an ethical foundation and because seeking to achieve it in practice does more harm than good.

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SOCIAL COHESION: LESSONS FROM THE PAST

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NELSON
17 MARCH 2000

SOCIAL COHESION: LESSONS FROM THE PAST

Over the past 15 years, much of the political debate about 'old' New Zealand has focused on the economy. New Zealanders came to understand that since the Second World War, and particularly by the 1970s, the country's living standards were not keeping pace with those of leading countries. David Lange spoke of the 'Polish shipyard', the heavy hand of government control that extended into almost every recess of commercial life. The business sector suffocated under a tangled web of regulations and subsidies that all but snuffed out its capacity for wealth creation.

We joke today about many of the more eccentric features of the Fortress New Zealand era. Many imports were simply banned. It was against the law to make carpets from anything other than wool. To buy margarine you had to get a doctor's prescription. Until 1967, hotel bars closed at 6 o'clock in the evening. You were not allowed to truck goods more than 40 miles. To buy Australian shares you had to apply to the Reserve Bank of New Zealand. You bought 5 shilling British postal notes to subscribe to overseas magazines.

I will not go on. Most New Zealanders, whether enthusiastically or grudgingly, came to accept that New Zealand could not survive as an economic museum. Many, however, do not realise to this day how many relics of old New Zealand are still around us. It is still not legal, for example, to sell apples and pears and dairy products to a foreign buyer without a permit, or to own more than one pharmacy. Governments still take and spend about 40 percent of national income compared with about half that ratio 50 years ago. Many people have not noticed that while New Zealand just sat on its hands for most of the last two parliaments, other countries like Australia kept reforming their economies and are now outpacing us again. And the new government seems to want to turn back the clock in all sorts of ways, ranging from restoring the state monopoly in accident compensation to bringing back area health boards, repealing the Employment Contracts Act 1991 and making trans-Tasman shipping a closed shop again.

However, I do not wish to dwell on the economy, past or present. If New Zealand continues to ignore the lessons of economic success here and elsewhere, the public will sooner or later recognise the mistakes and press for changes, although the cost will be slow growth in incomes and needless unemployment in the meantime. Instead, I want to explore some other aspects of old New Zealand that I believe have lessons for the future.

Many people think we have lost some of the things they valued about New Zealand in earlier days. They use words like the "decent society" and "social cohesion" to describe them. They are disturbed by the incidence of family breakdown, unemployment and crime. They see too many people, especially Maori, as trapped hopelessly in poverty. They remember a time when New Zealand did not seem to have many of these problems, and they do not see why we should tolerate them today.

I have a lot of sympathy with these concerns. Where those who express them sometimes go wrong is in linking them to the changes of the last 15 years. New Zealand was not a happy, prosperous, cohesive society by the 1970s and early 1980s. I was the chairman of the Steering Committee of the Economic Summit that met in 1984. The communiqué of that summit spoke bluntly of "an unacceptable level of poverty", people with "major difficulties with housing, health care, and meeting essential family needs", "a decline in social services" and "increasing social discontent". By 1984 any illusions that we were 'a land of milk and honey' or living in 'God's own country' had long been shattered. We would not have needed that summit if it had been otherwise.

I am old enough to have lived through the period that some look back to with nostalgia. I grew up in a farming community during the depression years. Large numbers of people were wandering about the country looking for work, and there was often a swagger in our woodshed. However, my parents never locked the door of the house, because neighbours might have wanted to pop in to use the phone or make a cup of tea. Despite unemployment and hardship, the crime rate was far lower than it is today.

I can just remember the first Labour government that was elected in 1935 and the social security measures of 1938. Some people today seem to regard the government of Michael Joseph Savage as one that launched New Zealand into big government and large scale welfare. Nothing could be further from the truth. In an editorial last year, the *Evening Post* correctly observed:

> It's an unpopular view, but the Welfare State founded by the First Labour Government of Michael Joseph Savage is more in tune with the current philosophies of the National and Act parties than those of Labour and the Alliance.

Even though Savage's government boosted government spending, it still amounted to only 16.6 percent of gross domestic product (GDP) in 1938. Savage and Nash were fiscal and moral conservatives. Welfare was seen as a temporary hand-up, not an open-ended handout. Savage insisted that pensions should be means-tested, not paid on a universal basis regardless of wealth. His government was very conscious of the risks of state welfare undermining the role of the churches and charities. Many of its members had grave misgivings about introducing compulsory unionism in 1936, fearing that it would make unions domineering and unaccountable. By the late 1940s, these fears were proving to be well founded.

The 1950s were often seen as the high point of the 'good old days' for New Zealand. Export prices were high and the adverse effects of Fortress New Zealand policies were only just starting to bite. It was a time of full employment when firms were free to hire and fire people provided they observed ordinary contracts. Things like today's so-called unjustified dismissal laws, the Employment Court and the Human Rights Commission had not been invented.

By today's standards, welfare dependency was minimal at that time. People accepted an obligation to find work. They looked first to family, friends, charities and churches for help and support – not the state. Most people hated going on the dole and only did so as a last resort. Adoption was usually seen as a better solution than sole parenthood. Thrift was regarded as an important value. People expected to have to save for their own retirement, with the pension being a residual safety net. Until 1960 the Universal Superannuation payable, without a means test, to all over 65 years of age was a small sum. Before the fads and fashions of the last 30 years, education focused on the basics.

Consider too some of the moral values that were reflected in the laws of the time. The law frowned on public drunkenness and loitering. It was an offence to have "no visible means of support" – a far cry from later attitudes towards welfare. Criminals were not generally seen as "victims of society"; previous generations expected citizens to be law-abiding and supported laws, policing and penalties that kept crime to low levels. It would have been unthinkable to hear a minister of the church condoning theft in those days. Students going overseas to escape debt obligations would have been regarded as morally bankrupt.

I do not look back on that period with rose-tinted spectacles. The New Zealand economy was already starting to seize up by the 1950s with lower productivity growth rates than our trading partners, for reasons that include things like the introduction of import licensing and exchange controls in 1938. Some of the social legislation of the time was unduly harsh. Some children did not get good educational chances. There was a certain grey conformity and repressiveness in the national culture. As late as 1961 there were only three licensed restaurants in Auckland. BYOs were illegal everywhere. The film of James Joyce's *Ulysses* could only be shown to segregated audiences. Many practices held women back: for example, they often had to get their husband's permission to open bank accounts. I marched against the Springbok tours.

For all that, there was much more that was good than not about the environment of the middle years of the last century. The worst mistakes came later. Governments abandoned fiscal conservatism and greatly over-reached themselves in bidding for votes without acknowledging the consequences. Government spending and taxation grew enormously. With higher taxes, people found it more and more difficult to provide for needs such as housing or saving for retirement. Governments then started to spend more on things like housing and superannuation themselves, which only raised the tax burden further. Married women entered the workforce not just as a matter of choice but in order to help make ends meet. This put more pressure on families. The terminus of this process is today's calls for childcare subsidies and paid parental leave – ordinary families become wards of the state.

The need for state welfare should have fallen sharply after New Zealand recovered from the depression years and with the prosperity of the 1950s and 1960s. Instead, it grew with more expansive programmes such as the accident compensation scheme, the domestic purposes benefit and National Superannuation being introduced in the 1970s. In the process, the social roles of organisations like the church and charities were displaced.

Some people say that the sacrifice of freedom associated with the welfare state is a price worth paying to obtain more security and more social cohesion. The history of the last 30 years has shown, however, that as the expansion of government expenditure becomes increasingly unaffordable, the welfare state provides no more security than quicksand. Nearly a million people – one in four New Zealanders – are now dependent on the state, that is, on the taxes paid by other people, for income and employment assistance. Rather than strengthening social cohesion, the welfare state has become a source of discontent. The politics of social welfare now seems to be concerned primarily with actions by various groups to exercise their political muscle to preserve what they have come to see as 'entitlements'. Savage and members of the first Labour government would not recognise today's welfare state. There is a crying need for debate to be re-focused back to the question of how to provide effective help to the people in most need of assistance at least cost to the broader community.

The underlying belief during the last 30 years has been that bigger government enhances social cohesion. This view lay behind the expansive recommendations of the 1972 Royal Commission on Social Security with its language of participating and belonging. Supporters of this view favour greater public spending and taxation in the hope of reducing income gaps. They prefer universal subsidies to services such as health and education, regulation of the labour market and minimum wages, and more funding for things like culture, Maori grievances and declining regions.

The practical difficulty with this view is that bigger government approaches to social cohesion have been tried time and time again. We have at least 40 years of experience with them to reflect on. They have not worked; indeed they have contributed to the present discontent. The more fundamental difficulty is that big government uses force to suppress alternative choices. This is inherently divisive. So too is the modern tendency to legislate to deprive individuals of the freedom to make moral choices: too easily it leads to the tyranny of political correctness. Ultimately, as governments have over-extended themselves, we have seen a decline in public support for democratic institutions, and for the idea of one rule of law for all.

Those people who think New Zealand enjoyed greater social cohesion before the big government era are right, and we need to re-learn some lessons from the past. We find the same lessons from the Asian societies where levels of government spending, taxation and welfare are much lower than ours, and which enjoy lower rates of unemployment, less family breakdown, fewer solo parents and less crime. Another lesson comes from the

United States where in recent years a strong economy, a falling ratio of government spending, flexible labour markets and reforms to make state welfare more restrictive and conditional have led to improvements in virtually all social indicators. A *Wall Street Journal* editorial observed recently that doing well in the new economy "increasingly means fidelity to the old verities: stable families, a decent education, and a willingness to forgo immediate indulgences for future (compounded) benefits".

Socialist rhetoric derides those who favour smaller rather than bigger government in promoting a decent society as "rampant individualists" who lack a "sense of community". However, the proposition is absurd: one of the first modern proponents of limited government, Adam Smith, wrote that "In civilised society [man] stands at all times in need of the cooperation and assistance of great multitudes, while his whole life is scarce sufficient to gain the friendship of a few persons". Smith stressed the importance of markets and civil society for social cohesion. He saw "improvements in art and industry", "civilisation", "order and good government" and "the liberty and security of individuals" as positively linked together. This is a vision of peaceful co-existence among people who do not strive to exert coercive power over each other.

Achieving greater social cohesion means reconstructing the values and institutions that helped produced it the past. It means strengthening the institutions of civil society – families, firms and voluntary organisations – and shrinking political society. It means emphasising the rule of law and the role of markets, competition and choice. In the free marketplace, people are not forced to do anything but they have to cooperate to succeed. Achieving greater social cohesion also means recognising that there are no rights without responsibilities and that actions have consequences, and it means rewarding and honouring the virtues of honesty, decency, self-reliance, charity, thrift and hard work.

Above all, achieving a cohesive society means upholding the freedom and responsibility of the individual. Cohesion will never be built on coercion, as the devisiveness of socialist societies demonstrates. When people are compelled to do things they inevitably resist. Nor can the state make individuals morally responsible. These beliefs lay at the heart of the founding of America, and although they have been battered and eroded over the years, they are still what makes America strong. The main theme of President Clinton's millennium address was that "The sun will always rise on America as long as each new generation lights the fire of freedom". Any US president would have said the same thing. By contrast the word 'freedom' did not feature in Helen Clark's millennium address. The prime minister spoke of poverty, equality, security, identity, justice, fair play and the environment, all of which I can relate to. But never once did she speak of freedom. I suspect that the value of freedom might also have been overlooked if Jenny Shipley had been giving the address.

A theme of this Rotary district conference is continuity, and my contention is that there has been a loss of continuity in upholding a commitment to freedom and responsibility in our society. The older generation in New Zealand had a better understanding of freedom: they went to fight in foreign wars to preserve it. At home, although they looked to the state to undertake many core functions, they kept it within limits, even up to the 1930s. That generation knew that bigger government meant less personal freedom. They understood the connections between freedom and responsibility. The true father of the Alliance, and Michael Joseph Savage's archrival, John A Lee, did not. He wanted the state to make people behave responsibly, saying, for example: "If there's one thing that New Zealand will live to regret, it's the abolishing of the six o'clock closing system". Few, if any, would agree with John A Lee today. With greater freedom in drinking has come greater responsibility, if still not enough; bad habits take time to change.

Yet, the same statist thinking came through in the previous government's attempt to introduce a Code of Social and Family Responsibility. There was nothing much wrong with what was in the proposed code; the problem was that it was a state initiative. And the problem with the reaction of church and welfare groups was that they did not tell the government to butt out and reclaim this ground for themselves; rather, they accused the government of having a hidden agenda to offload its welfare responsibilities.

So the final thought I want to leave with you is this: in re-building social cohesion the institutions that lie outside the realm of the state must once again have a leading role. Rotary Clubs are part of civil society. So too are churches, charities, community organisations, private schools, hospitals and businesses. In countries that have tried harder to limit the role of government, such as the United States, support for these institutions has remained much stronger.

The institutions of civil society must ask governments to help them recapture the lost ground, for example by funding government and independent schools on an equal basis and by lowering taxes so that people can take more care of themselves and others. They should encourage young people to join organisations that help people in need, encourage charitable giving – Americans typically give a week's income to charity each year – and encourage wealthy people to engage in philanthropy. Above all, they should encourage a society of free and responsible individuals.

All this, I believe, is fully consistent with the charter of the Rotary movement. Membership of political parties and belief in big government as the way to a decent society are in decline worldwide. Membership of institutions of civil society like Rotary, and the promotion of their values, are, I believe, the way of the future.

ACT NEW ZEALAND ANNUAL CONFERENCE

FAIRNESS

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NEW ZEALAND BUSINESS ROUNDTABLE

AUCKLAND
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FAIRNESS

As I reflect on the current political environment in New Zealand, I am reminded of the halcyon days of the Soviet Union. At that time, a Russian lady wanted to buy a new car. She went to the dealer, specified the car she desired and inquired about the delivery date. "Tuesday", said the dealer. "Morning or afternoon?", asked the lady. "What difference does it make?", inquired the dealer, "It's ten years from now". "Well", said the lady, "The plumber's coming that morning".

New Zealand never took socialism quite that far, but the legacy of 60 years of socialist thinking still weighs heavily on our culture and politics. Many members of the present government come from the hard left; several even belonged to communist parties. Margaret Wilson's belief that the relationship between employer and employee is one of inequality, which requires a collectivist response, could have been borrowed from Karl Marx. The government seems intent on travelling back down the command-and-control path that led to inefficiency, impoverishment and injustice in so many countries, and to New Zealand's economic slide.

Last year the Labour Party campaigned on a moderate platform, giving the impression that it accepted the realities of contemporary economic life and would make only minor changes to recent policies, just as Tony Blair's Labour government in Britain has accepted most of the legacy of previous Conservative governments and indeed extended it. In office, however, Labour and the Alliance have called a halt to economic reform and are unfolding a much more radical, backward-looking agenda, reminiscent of left-wing ideas of the 1960s and 1970s. What they are trying to do can genuinely be described as reactionary; they are putting New Zealand on a course that no other Organisation for Economic Cooperation and Development (OECD) country is following. It remains to be seen whether the electorate thinks this is the programme it voted for.

In opposition, both the National and ACT parties clearly need to do some soul-searching. In the week before the election, the *Otago Daily Times* hit the right note in an editorial when it said:

> . . . it would be a hard task to find a voter who could actually describe what National's policies for the next three years actually are, other than the tax cuts. National's planners chose as their election strategy the party's record in government, thus burdening Mrs Shipley not just with the responsibility for her brief and mixed term as prime minister, but for the whole of National's last three terms.

After its initial liberalising efforts of the early 1990s, National became lazy and smug. It stopped listening to the business community. It did little to educate the public about the challenges and opportunities of the international environment in which New Zealand has to operate. Buzz words like 'decent society', 'social capital' and the 'knowledge economy' substituted for policy substance. National's failure to maintain efforts to strengthen the economy, which fell back into recession, discredited the reform programme in the eyes of many. Sporadic initiatives to deliver real gains, like the accident compensation scheme reforms, were tardy and half-hearted. National gave the country no reason to believe it would lead New Zealand into a brighter future.

ACT increased its share of the vote but only marginally. It, too, needs a new framework and vision. ACT's general philosophy is sound, but its core commitment to smaller, better government seemed to become blurred in the run-up to the election. Moreover, ACT's attachment to various forms of compulsion in social policy areas has compromised its commitment to individual freedom and choice. ACT should be, and be seen to be, above all else a party favouring freedom. As I will argue, ACT should campaign for freedom on grounds of fairness and wider opportunities for all – including the poorest – as well as enterprise and prosperity. It needs to translate these principles into a more coherent programme.

ACT needs to challenge the electorate. It must ask New Zealanders whether they really want to return to a nanny state and the mediocrity that goes with it, or whether they want the higher living standards and greater opportunities associated with economic and social freedom. Are voters more concerned with alleviating poverty or equalising incomes? Are they happy at the prospect that New Zealand's brightest and most energetic people will vote with their feet and seek more stimulating and rewarding careers elsewhere? ACT must explain to voters why socialist dreams turn routinely into nightmares. The fact is that in the real world we have to cope with the frailties of human nature and the limitations of government. In this world ACT must spell out how we can achieve a more just society by embracing an open and competitive economy while protecting those who are genuinely in need.

Thus I come to my main theme which is fairness. Let me begin by quoting from a new version of the fable of the ant and the grasshopper, which I think encapsulates some of our national habits of mind rather well. In the original story, you will recall, the ant works hard in the summer heat, building his house and laying up supplies for the winter. The grasshopper thinks he's a fool and plays the summer away. Come winter, the ant is warm and well fed. The grasshopper has no food or shelter and so he perishes in the cold. Lindsay Perigo has recently updated the story as follows. In this version:

> . . . the ant works hard in the withering heat all summer long, building his house and laying up supplies for the winter. The grasshopper thinks he's a fool and plays the summer away. Come the winter, the shivering grasshopper calls the *NZ Herald* and demands to know why the ant should be allowed to be warm and well fed while others are cold and starving. The Holmes Show provides graphic footage of the feverish grasshopper outside the comfortable home of the ant, who is seen feasting at his table. Retired trade unionists and current government employees, all from England, are outraged by the disparity, and set a new record for whining on Radio Pacific. A representative of the Grasshoppers' Right of Stagnation Society, GROSS, says the grasshopper is the victim of discrimination on the basis of effort, and demands that 'effortism' be outlawed forthwith.
>
> Jane Kelsey writes in the *NZ Herald* that the ant has gotten rich off the back of the grasshopper, and calls for immediate action by the government to restore equity. The IRD confiscates the ant's home and gives it and the food therein to GROSS. The grasshoppers finish up the last bits of the ant's food just as the house starts to crumble around them since they don't know how to maintain it. Soon they are starving and shivering again. Winston Peters wakes up with a start and calls for a public inquiry. Richard Prebble says grasshoppers should be forced to build houses and save up food in the summer. Helen Clark, Linda Clark, Michael Cullen and Jim Anderton all promise to confiscate more ant houses and ant food for the grasshoppers in the future. They are voted into power by the retired trade unionists and current government employees. The *NZ Herald* proclaims the beginning of a new era of fairness.
>
> Twelve months later, everyone has died in the great New Zealand Famine of 2000.

Now I do not necessarily subscribe to all the sentiments in the modern fable, but the ruling ideas of fairness are ones that we need to reflect on. As New Zealanders we believe in fairness, in the idea of a 'fair go'. We are also attached to egalitarianism, in the sense of a classless society in which 'Jack is as good as his master'. Intellectuals and politicians, however, have distorted the traditional concepts of fairness and egalitarianism beyond recognition. One result of this process is the disastrous social outcomes suggested in the fable. But a deeper criticism is a moral one: it leads to policies and practices that have unjust outcomes.

A central focus of the political debate ahead should be on claims of fairness. The prime minister, Helen Clark, has stated her claim in the following terms:

> "[I]n most parts of Auckland, house and rent prices have soared beyond the reasonable reach of working people. The Government's lack of a housing policy now adversely affects those who have cared for their State houses with pride over three or four decades . . . [T]hose who live on national superannuation alone are finding life more and more of a struggle . . . Youth unemployment is a genuine concern . . . [T]he past few years have brought falling living standards . . . Our party was founded on concepts of social justice and equality . . . We believe that the State must act to correct the imbalances in our society, favouring the rich and powerful . . . We know that if the market is left to sort matters out social injustice will be heightened . . . The law of the unregulated market is, in the end, the law of the jungle . . . There is an immense job of social reconstruction to be done – a job that can only begin when a Labour Government, committed to social change and equality, is elected.

Interestingly, this quotation is not from a speech by Helen Clark during last year's election campaign. It comes from her maiden speech in parliament in 1982. Believe it or not, the "law of the unregulated market" that she was describing was the high point of Muldoonism – which culminated that year in comprehensive wage and price controls – not the moves towards liberalisation of the past decade-and-a-half. In her speech, Helen Clark declared her opposition to the proposed free trade area with Australia that would mean, she said, "an execution date for our structure of import licensing and export incentives". Yet at the last election the Labour Party's criticism of the policies of the past 15 years was essentially the same – they were 'unfair'. It seems that social injustice predated the reforms of the Lange-Douglas government, instead of being caused by them as we are so often told, and that it is due both to liberal and illiberal policies. To put it mildly, all this seems rather incoherent.

Modern parties of the left often claim they have a monopoly of fairness, and this purported monopoly allows them to appeal to less well-off members of society. Parties like ACT are accused of being 'uncaring', and they tend to draw their support from better-off groups. Should ACT resign itself to being perceived in this way, and to this limited support base? My answer is emphatically 'no'. Supporters of a liberal economy and society must confront these perceptions head on, and challenge the parties that currently claim the high ground on issues of fairness and social disadvantage.

A starting point for such a challenge might be found in history. ACT is wrongly seen as a party of the right, and supporters of liberal policies are wrongly described as 'right wing'. Those who operate by labels find it hard to associate liberal views with concerns for the poor. Yet the tradition of political liberalism to which ACT is an heir, originated with the political left. The liberals and radicals took their place on the left side of the chamber during the French Revolution. They opposed privilege: the statism, collectivism and hierarchical privileges of the *ancien regime*. This alignment persisted until the late nineteenth century; in Britain the mass of workers and even the early trade unions favoured the free competitive market as the best means of improving wages and working conditions. In the United States, the classical liberal party was the Democratic party, known in the nineteenth century as "the party of personal liberty". It championed the constitutional ideas of limited government and free trade.

The old order returned in the late nineteenth century with the rise of the socialist movement in Europe. There were similar developments in the Democratic party in the United States that led ultimately to the New Deal. Parties of the left came to be associated with ideas of collectivism, public ownership of firms, public provision of services such as education, and redistribution. Ironically the socialist left shared many of these ideas with the New Right in Bismark's Germany. In both cases policy was based on protectionism, the welfare state and corporatism – a network of controls, cartels and privileges forged in a partnership between big government and favoured elements in business.

By the end of the twentieth century, socialism and collectivism had run their course in most countries, but the identities of alternative political currents had become hopelessly confused. A central feature of Roger Douglas's reforms was the rejection of privilege. He set about dismantling import licensing, farm subsidies and regulations that protected vested interests. He tried unsuccessfully to break down the privileges of trade unions and the state health and education monopolies. Yet these attempts to remove barriers, introduce competition and create greater equality of opportunity, particularly for the least privileged, were not recognised as typical policies of the left. The support of business organisations for dismantling corporatism was labelled New Right thinking.

This confusion between left and right labels persists today. An important task for ACT is to expose the fact that many of the new government's programmes are reactionary, not liberal, and that they are neither fair nor effective as approaches to social disadvantage. Rather, the policies are the phantoms of an archaic ideology, cloaked in new appellations that disguise their true purpose: the promulgation of privilege at the expense of freedom. A sustained effort is needed to show that many new government initiatives are not only detrimental to the general population, but are particularly unfair to the poor. Maori will be among the worst affected; they will become further entrenched in a culture of dependency.

To illustrate my argument, let me start with the proposed changes to the Employment Contracts Act 1991 (ECA). Unlike the British Labour Party, which accepted most of the Thatcher government's reforms of labour law – with the result that Britain probably has a freer labour market than New Zealand today – Labour in New Zealand is set on an ideological mission to turn the clock back. The proposed changes are very likely to raise the costs and risks to firms of employing staff, reintroduce inefficient work practices and increase industrial disruption. But they are also fundamentally unfair because they constrain the freedom not just of firms but also of their staff to enter into the kind of contracts that suit them best. The true beneficiaries are unions; union privileges that were removed by the ECA are being restored. The losers are ordinary people.

Next, the government's action in increasing minimum wages is no way to help the poor. Only a fool or an intellectual could believe that wages can be increased by legislative fiat without causing losses to some members of the workforce. To assert the opposite merely begs the question as to why wages should not be raised further. In the paper presented to the cabinet, government officials advised that "The gains to some low-income earners will come at the cost of lost employment opportunities to others" – they suggested between 1300 and 5200 jobs were likely to go. This is likely to swamp any net increase in jobs from industry development handouts. The government officials said that, "Increases in the minimum wage may hinder the transition of more disadvantaged workers into jobs". They also pointed out that "As a tool for achieving income distribution objectives, increasing the minimum wage is at best a blunt instrument, and other instruments are available". Minimum wages are an unfair policy; they hurt the most marginal workers whose best chance is to get a foothold on the employment ladder. Why is the government ignoring the advice of its own advisers unless it wishes to pander to labour unions driven by the interests of those in work rather than the unemployed? For unions, the unemployed have always been the competition.

The government is restoring the state monopoly for accident compensation yet elsewhere it professes to be concerned about monopoly behaviour. Is this principle or politics? Like the ECA changes, the move seems to be a payoff for union support for the Labour Party. Certainly workers' interests do not enter into the picture: what is fair about being denied choice and being forced into a one-size-fits-all scheme? Why should workers want the money that could be used to increase their wages spent on a less satisfactory insurance policy?

What about taxes? Many commentators have pointed out that for talented entrepreneurs the negative impact of the increase in the top personal tax rate will again swamp the effects of interventionist plans to stimulate entrepreneurial activities. The increase in the rate was justified as a means to fund additional social spending. This argument does not stack up. A decision to help those on low incomes is unrelated to how the transfers ought to be funded. If concerns about equity are motivated by compassion for the poor, rather than envy of the rich, the best and fairest policy is to fund transfers through a single flat tax. Envy of high achievers is the only plausible motivation for a progressive tax scale. What is fair about a decision by a political majority to raise the tax rate on a minority?

What is more, it is hard to reconcile the government's argument on tax with its argument on tariffs. The Alliance has criticised the goods and services tax for being regressive. In fact it is roughly proportional, as over their lifetimes most people spend what they earn. By contrast, tariffs now fall mainly on textiles, clothing and footwear, and these account for a disproportionate share of the spending of low-income households. Labour and the Alliance want to freeze or raise tariffs and perpetuate a regressive tax. Is this fair?

Tariffs also increase the returns to the owners of protected firms or the wages of their employees at the expense of consumers at large. What is fair about this form of redistribution?

Consider industry policy. The government wants to go back to "assisting" firms through taxpayer subsidies. The main objection to this policy is that it is an absurd illusion that the economy can be hauled to higher levels of performance by foolish tinkering. But there is also a fairness aspect. By definition the government cannot assist all firms, so it has to be selective. The old guard among New Zealand manufacturers who specialised in lobbying have already got their hands out. Some firms will be favoured while others will bear the costs through higher taxes and higher prices for resources. Where is the fairness in this? In agriculture, the government has scrapped the producer board reform team. It seems likely it will favour the interests of those involved with the marketing monopolies at the expense of farmers and growers who want choice and at the expense of the interests of the wider community. Is this fair?

The government seems intent on regulating company takeovers. Incompetent chief executives should go down on their knees to give thanks, as such regulations make it more difficult for alternative management teams to take over poorly performing companies. But what is fair about protecting failed management at the expense of shareholders and other stakeholders? Why should a company's shareholders be denied the opportunity, which they have at present, to choose the takeover rules they want?

In the social services area, the government is clearly bent on shoring up the state monopolies in education and health. It is shutting down contracting arrangements with private health providers and abolishing the schemes that enable children from low-income families to attend independent schools. The government tells us that the latter undermine state education. But is education for the benefit of schools, teachers and teacher unions or for the benefit of children and parents? What is fair about trapping children in an under-performing school from which their families want them to escape? Freedom of choice is of greatest benefit to poor families. For many disadvantaged children, education is their one ticket out of poverty; if they miss that train, they risk missing everything.

The government is increasing the subsidisation of tertiary education by scrapping interest on loans while students are studying. Who benefits? Those engaged in tertiary education typically come from better-off families and go on to earn higher incomes in later life. One can make a case for targeted scholarships to students from low-income families, but universal student subsidies are a transfer from poor to rich. Is this a fair policy?

The previous government dropped the surcharge on New Zealand Superannuation and the present government is committed to retaining universal payments at an increased level. As a result middle- and lower-income earners are being taxed to fund the retirement income of millionaires. Is this the average person's idea of fairness?

I could go on, but I trust I have made my point. After a period in which New Zealand governments started to eliminate economic distortions and interest-group privileges built up over decades of socialism, and sought to direct public help to those in genuine need, we seem to be going back to the days when special interests and political constituencies dictated policies and reaped government favours. We are seeing the interests of union, tertiary student, pensioner and some business lobbies taking precedence over those of less well-off consumers, taxpayers and the public. All these policies can be criticised on the grounds that they are harmful for living standards and economic growth, but they are equally open to criticism on the grounds of fairness. Freedom is good for both.

There needs to be a broader debate over what constitutes fairness. The New Zealand Business Roundtable will shortly be contributing to that debate with a publication that examines equity as a social goal. Fairness has many attractive dimensions. Equality before the law in a civil society is a vital goal. So too is safeguarding each person's right to their person and property. An equitable society is one in which individuals have the same rights to pursue their own personal interests, provided they do not infringe on others' rights to pursue their goals. Principles of equity also support a case for a public safety net if reliance on savings, insurance, families, friends and private charity is insufficient to prevent genuine hardship.

Fairness also requires a distinction to be made between poverty and inequality. Compassion for people in dire circumstances is a proper motive for public policy. By far the most powerful form of poverty relief in most cases is plentiful employment opportunities in a growing economy. The Labour government stifled such opportunities when it was last in office by its refusal to free up the labour market, and unemployment soared as a result. The new government is poised to repeat that mistake. The prime minister has set a goal of getting the unemployment rate down to 3 percent, but the government is re-regulating the labour market and making welfare more attractive relative to work. This is a glaring inconsistency.

Helping the poor by way of promoting jobs and growth and providing a social safety net is a different goal from that of reducing inequality. While helping the poor is founded on compassion, a concern for inequality has much more to do with envy and has little to commend it on grounds of fairness.

Most professional economists believe a change is good if it makes someone better off without making anyone else worse off. There has been a relatively greater increase in higher incomes in many other countries in recent years, and incomes of the most skilled in New Zealand have risen too, partly in response. However, the relative position of the lowest income group in New Zealand has been broadly maintained, and many individuals in the lowest category have moved up the income ladder over time. Recent developments have, however, interrupted a long-run international trend to more equal incomes, which may well resume in due course given the equalising effects of competition. The main reasons for the recent changes internationally appear to be greater rewards to high skills, the rise of entrepreneurial activities, longer hours being worked by high-wage individuals, an increase in two-income families and the wealth effects of strong investment markets. It is hard to see what objections can be raised against these sources of higher incomes: they benefit some without reducing the incomes and wealth of others and, in the United States at least, the rising tide is lifting all boats, including those of the poor.

A thought experiment demonstrates easily why reducing inequality can be absurd as a social goal. Suppose Bill Gates decided one day to transfer Microsoft and all its staff to New Zealand. You would think this prospect would be welcomed with open arms:

Microsoft is the most powerful symbol of the knowledge economy, it is in a non-polluting industry, it provides high-paid jobs and pays taxes, and there would be no demands for state subsidies and few implications for welfare.

But you would be wrong. About a quarter of Microsoft's staff are reported to be millionaires. It would not be long before a poverty researcher at one of our universities pointed out that the arrival of Microsoft would increase income inequality in New Zealand and, given the way relative poverty is measured, increase the percentage of households who are said to live in relative poverty. On this criterion, Microsoft's relocation would be a bad thing.

A more mundane demonstration of the same result is that additional enrolments in tertiary education worsen income inequality, first by increasing the proportion of the population on low incomes and later by increasing the number of university graduates earning higher incomes. Yet not only does the government welcome that trend, it is increasing the subsidy for this growth in 'inequality'.

We need a proper debate about the notion of fairness. Too many claims and charges are going unanswered. Take the frequent claims about 'greed'. Of course there is such a thing as greed, but it is not the same as working hard to get on in the world, support your family and be self-sufficient. As the economist Thomas Sowell has said, "I have never understood why it is 'greed' to want to keep the money you have earned but not greed to want to take someone else's money". Compassion for those in need is a proper aspect of fairness, but compassion needs to be distinguished from a desire to reduce high incomes that are fairly earned in a competitive market. The latter can only be motivated by resentment and envy. Envy used to be regarded as one of the seven deadly sins, but too often it masquerades as social justice today. Pandering to people's worst feelings and buying votes with other people's money is not evidence of compassion. Nor is compassion measured by the level of state spending.

New Zealand is not going to get over its present discontents and settle permanently on sounder policies until we think more clearly about these issues. The debate is not primarily about *goals*: fairness, properly understood, is a valid social goal. Rather, the debate is about the *means* of promoting a fair society. The prevailing assumption in New Zealand and many other countries has been that command-and-control policies, high taxes and extensive state redistribution produce a fairer society. The American journalist, Walter Lippmann, pinpointed the problem with this assumption many years ago. He wrote:

> The collectivists . . . have the zest for progress, the sympathy for the poor, the burning sense of wrong, the impulse for great deeds, which have been lacking in latter-day liberalism. But their science is founded on a profound misunderstanding . . . and their actions, therefore, are deeply destructive and reactionary.

Few governments in office today argue that state-sponsored collectivism is an engine of economic prosperity, but neither is it an engine of social equity. Evidence from the former socialist countries and the welfare states of Europe demonstrates that an excess of enforced collectivism breeds poverty, privilege and divisiveness, not the compassionate and cohesive societies that both liberals and well-intentioned collectivists desire. Rather, societies need to preserve a high level of freedom for individuals to pursue goals of their own choosing, constrained by the rights of others, if they want both prosperity and social cohesion. Not all their projects will be individualistic; often individuals will band together freely without government compulsion to pursue their goals. Team New Zealand is a classic case in point.

It has been said that the socialists have had all the good tunes, and they have certainly succeeded in making their opponents, and those trying to clear up the mess afterwards, look uncaring and hard-hearted. History and evidence, however, are not on their side. I pointed out that, historically, those on the left favoured what we would today describe as liberal policies. Those who criticise the legacy of socialism in New Zealand, and current attempts to resurrect it, must recapture the high ground. Even centre-left governments in Europe, which for years were critical of the allegedly 'harsh' features of American capitalism, are changing direction in the face of evidence that the United States is out-performing Europe in dealing with problems of social disadvantage. By contrast, New Zealand is now headed in a direction that is destined to make it a poorer country, and to damage the interests and prospects of poorer New Zealanders in particular. Not one of the government's policies that I enumerated promotes fairness.

So the challenge for true liberals – whether of the left or right, if those terms have any residual meaning – is to express confidence, conviction and passion about how New Zealand can and should be both a more prosperous and a fairer place with greater personal freedom, limited government and open, competitive markets. True liberals have every right to heap scorn and derision on the arrogance and morality of big government with its endless pathologies of unintended side effects, capture by vested interests, corruption, waste and incompetence. They must dismiss as nonsense the claims that their programmes are uncaring and hard-hearted. They should summon up the buoyancy and optimism of politicians like Ronald Reagan in reaching out to ordinary people and describing what this country could be like if people were free to use their creativity and energy in pursuit of their own dreams.

Part of this task, I have argued, must involve a special focus on fairness. New Zealanders relate to fairness, and rightly so. Fairness has been a trump card for socialists, but their ideology is bankrupt. There is a huge task to articulate a consistent alternative framework to help New Zealanders grapple with fairness issues. The ACT party and other liberals must think through how to challenge the prevailing climate of opinion and restate sound concepts of fairness in a way that the average person can understand. They must make the distinction between fair opportunities and compassion on the one hand and favouritism, privilege and envy on the other. They must explain that fairness does not consist in knocking anyone who sticks their neck out or makes a mistake, and deriding rather than celebrating initiative and innovation. They must make their vision of a fair and prosperous society compelling. Unless they do so, people will be driven to populist causes, and ACT will too.

New Zealand did not become a first-world country through big government. It flourished when governments were smaller and concentrated on the core roles that only governments can undertake. Its success was due to the efforts of its pioneering men and women building a new life for themselves in a remote and difficult land. They were self-reliant and they helped each other. They did not believe that being your brother's keeper meant delegating the job to Big Brother. Those who understand what made New Zealand a fair and prosperous country must summon the passion to make it one again.

NEW ZEALAND INSTITUTE OF HEALTH MANAGEMENT
1999 CONFERENCE

NEW ZEALAND'S HEALTH SYSTEM: STILL OPERATING BEHIND THE BERLIN WALL?

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WELLINGTON
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NEW ZEALAND'S HEALTH SYSTEM: STILL OPERATING BEHIND THE BERLIN WALL?

Question: What sets our health system apart from most of our other mechanisms for meeting our needs?

Answer: The Berlin wall.

This was the response of one of my economist colleagues to a presentation about New Zealand's health reforms a couple of years ago.

The presentation was by a committed health professional. He had been practising in one of our larger hospitals for many years. His description of the problems he had experienced was humorous, eloquent and convincing. It also conveyed poignantly the depth of his frustration and despair. One transparency showed a cartoon of himself trapped inside a small monkey's cage, unable to put his skills to effective use.

As I recall, he was concerned about the pursuit of commercial objectives for hospitals, the bewildering 'business speak' of his new managers who did not seem to understand how hospitals actually worked, and the 'new right' terminology behind the reforms. He could tolerate at a pinch the offensive concept of professional capture, but was worried that it had been elevated to a dogma that was overriding genuine professional concerns. In his mind the problems were due to the reforms, not the system. More money and greater professional control would solve the problems.

As I see it, there is no doubt that our two large nationalised industries, health and education, are major sources of community dissatisfaction. Yet we are still nowhere near to arriving at an accurate diagnosis of the problems and to getting a consensus on effective solutions.

The greater professional control sought by our health professional could simply exacerbate concerns about professional capture and disempowered patients. At present, too much of the health sector looks like a closed shop. To what extent do our occupational licensing arrangements protect patients as opposed to providers? Do they block attempts to attract offshore professionals to New Zealand? Why do we regulate to protect pharmacists from competition when other government agencies are doing everything they can to reduce the cost of pharmaceuticals?

More funding would not alleviate taxpayers' concerns about the absence of proper incentives to provide value for money in the health sector, as illustrated by periodic manifestations of gross waste in building programmes and computer systems. Nor can more money solve the problem that sooner or later all health systems have to deny services to some who would benefit from more treatment. The resources needed to provide health services are scarce and sometimes costly. Under all systems services must be rationed. No society could afford to spend millions of dollars prolonging for a few days, weeks or months the lives of each and every elderly or terminally ill patient. Harder, equally inescapable rationing decisions arise where the quality of life of someone with a chronic condition can only be improved at great cost.

In addition, members of the public have no peace of mind about what level of care they are entitled to receive in return for their tax dollars. Allocations become a matter of political pressure, and we end up with high-profile cases on the Holmes programme. More money cannot solve this problem either.

The health professional's presentation was well received by his audience. But my not unsympathetic colleague questioned his analysis. He wanted to ask why we have this idea that health services are so unusual that health professionals have to operate in a quite different environment from accountants, lawyers, architects, veterinarians and other professionals. The history of government failure is littered with mistaken attempts to treat issues ranging from agriculture to labour markets as special. Even vast tracts of the health sector such as the manufacture of pharmaceuticals, chemist shops, dental practices, laboratories and indeed most primary care are run on normal business and professional lines. Why do we somehow conclude that secondary care has to be a nationalised industry?

Professionals do not view profit as a dirty word when it accrues as professional income, and they commonly work for for-profit organisations. What is a general practitioner (GP) practice if it is not a for-profit business? The profit motive once attributed to Crown Health Enterprises (CHEs) cannot explain why hospital professionals have to endure so much more frustration.

Why is it that a raft of factors sharply divide the hospital professional's position from those on the other side of the Berlin wall? In most walks of life, professionals can practice on their own or join a firm that may be run by non-specialists. If they are in a firm whose managers do not know how to get the best value out of their skills, their remedy is to find another employer, or start their own firm.

At least in a for-profit environment, professionals do not normally feel any serious frustration about the level of funding. The professional is there to supply the services that clients want to buy. Clients, professionals and their managers can agree about this. Whether professionals get funding for better facilities is essentially determined by their ability to persuade clients that the extra services are valuable and to persuade colleagues or managers that client demand justifies the expense.

In contrast, our hapless health professional has few choices except to try to pull the levers of a politicised and unresponsive system. His story reminded my colleague of the apocryphal tale of the Soviet factory worker who could not contain tears of frustration on reaching the age for compulsory retirement. He had not been permitted to do a decent day's work in his entire working life.

No doubt the factory worker, like our health professional, felt comfortable with a politically organised system, but wished that better people were in charge. In an ideal world that might be a solution. If governments, politicians and bureaucrats were perfect we would not need private enterprise and markets. However, governments are not perfect and cannot be made perfect. It is no accident that they stumble from one folly to another when they take on too much.

The task of the public policy maker is to ascertain the point at which further government intervention is undesirable, taking the imperfections of governments and markets into account.

Governments should focus on the core activities of the protection of life, liberty and property and the provision of public goods that cannot be better provided privately. Examples of situations in which public good issues arise include defence, law and order, communicable diseases, basic research and environmental problems such as pollution. Governments also have a role in providing a social safety net.

The flip side of this is that, as a rule, private goods are best supplied and funded privately. Outside the public health area, most health services are private goods. The consultation with my GP and my hip operation are rivalrous and excludable – they do not satisfy the criteria of a public good. They deny someone else the opportunity to use the same services at the same time, and I can be excluded from the services if I do not pay.

This basic public policy analysis pushes us toward private provision and funding of most hospital services. There is a big gap between analysis and current reality.

When we look systematically at what the government is doing in health, the key features remind us of life behind the Berlin wall – near-blanket suppression of the price mechanism and dominant state ownership and control. It is true that New Zealanders have access to private health insurance, and that some hospital services are provided privately. Nevertheless, the Berlin wall analogy is apt. Lord Beveridge, one of the architects of Britain's National Health System, saw it as taking Britain "halfway to Moscow". Recent statistics support his assessment. British sufferers of a range of life-threatening conditions have amongst the lowest survival rates in Europe. A recent editorial in *The Sunday Times* ruefully observed that:

> For many people with a life-threatening illness, the widely held view that the NHS offers a world-class service is tragically untrue. For those whose condition requires surgery, the shock of discovery is acutely distressing. International comparisons show the discrepancies clearly. British sufferers from breast and colon cancer have a lower chance of survival than in most of western Europe. Anyone with heart, respiratory or kidney disease is also at a disadvantage.

What are the systemic problems that arise when the price mechanism is suppressed and state ownership and control dominate?

The first problem is that without a price system it is impossible to determine the best use of a professional's skills. This is because there is no way of assessing value for money. The value-for-money problem arises because a state-controlled system faces two imponderables, the determination of cost and value. Take cost first. In the absence of competitively determined market prices, administrators do not really know the economic cost – that is, the opportunity cost – of the resources used in supplying services. They have an estimate of course, but it is based on arbitrary allocations of common costs such as overheads. Only competition can resolve the problem of which allocation represents the true opportunity cost. But even if professionals and hospital administrators knew their true costs, they would not know whether the services represented value for money. This is because they have no ability to look inside patients' minds. Value is a matter of subjective judgment on the part of those receiving hospital services.

Another problem is that when the provision of services is determined through political mechanisms, patients are disempowered. Others decide how their tax money is to be spent. Power shifts to the politicians, bureaucrats, administrators or health professionals who make funding decisions.

This contrasts with the normal way we get the services we need. Applied to health, this would involve us meeting routine health expenses out of current income or savings. Health insurance could cover low probability but high cost events. When we pay directly or through insurance for services we are concerned to obtain value for money. Under a competitive system of private health insurance, people would be attracted to insurers that best tailored their policies to their requirements and could be relied upon to meet valid claims. Competition for premiums would force private insurers to address the needs of the insured rather than those of politicians or other intermediaries, and insurers would have incentives to keep the costs of services down.

Mandatory state funding further disenfranchises people by depriving them of the security of a legally enforceable insurance contract. The state takes our money in taxes but fails to give us any certainty about what it will provide in return. Private insurers could never get away with this.

Politicians and bureaucrats try to justify tax funding on the grounds that 'no-one should be deprived of necessary services because of a lack of money'. As already noted, this is sheer dishonesty. No nation can spend unlimited amounts on health. Worse, each dollar the government takes from us in taxes to spend on health actually reduces the amount the nation can spend on health by substantially more than a dollar, because the deadweight cost of taxes results in a loss of national income.

State ownership of hospitals also disenfranchises patients. There are several ways in which a government hospital system can retain patients even if it does not provide value for money. One approach would be to ban private hospitals – we have not gone this far. A second, more subtle, approach, would be to regulate them out of existence. A third is to make public hospitals free to the user, while depriving private hospitals of access to a comparable level of state funding.

Our state hospitals provide critical care facilities free to the patient. Private insurers do not have access to such facilities at this price and so cannot compete in this area with the public hospital system. This commercial reality essentially restricts private hospitals to the provision of elective and other non-urgent surgery. These services are rationed in the public system via queuing.

It is this feature that allows public hospitals to become local quasi-monopolies that limit the choices of hospital professionals and patients alike, even if they fail to provide very safe care or value for money.

The absence of a price system in the delivery of health care produces other perverse outcomes. Our subsidies bias decisions in favour of expensive hospital care and expensive drugs rather than prevention in the form of changes in lifestyle and earlier visits to GPs. For example, obese people with a tendency towards diabetes do not face health insurance premiums that they can reduce if they lose weight or stop smoking. People may delay consulting a GP because they know they can get access to 'free' hospital care if the need becomes critical.

Our frustrated health professional, and many others working in politicised systems, are seldom very conscious of their inherent difficulties. They tend not to think 'outside the square' until the state becomes so over-committed that it can no longer sustain the system. In a recent book for the New Zealand Business Roundtable (NZBR), David Green made the point that the welfare state subtly deprives people of their independence, leaving them feeling powerless and frustrated while not understanding why.

Green argues that a good health system would need to satisfy the 'three inseparables' that he sees as essential for a civil society. These are: personal responsibility to provide for oneself, one's family and dependants, and those in need; voluntary association to achieve common objectives; and a government that is confined to maintaining the conditions for individual freedom and choice. Private hospitals, private insurance, private funding and private charities with a government safety net would conform far more closely with this prescription than a largely nationalised hospital system.

Rationing under private arrangements would be highly decentralised. First, risks would be pooled by private insurance, friendly societies, health plans and the like. Second, to the extent that insurance cover was not available, families would determine for themselves how much family wealth to commit to the care of one member at the expense of the rest. Third, voluntary organisations would ration their resources amongst cases that they regarded as deserving. The proliferation of options, arrangements and organisations would do much to depoliticise rationing decisions for much of the population. Individual cases of hardship would continue to make newspaper headlines, but private organisations could respond. The essential point is under a civil society, rationing decisions are spread much more widely around the community than under a politicised system.

The proponents of state ownership and control argue that it is unacceptable to ration health services according to income or wealth. But government funding and provision do not solve this problem. In our democratic society we cannot stop those who want to pay for more care out of their own pockets from doing so, whether or not they use private insurance as a vehicle. If necessary they can buy extra care overseas.

Reflecting on David Green's proposals, David Stewart, former dean of the University of Otago Medical School, has considered the degree to which greater reliance on personal and family responsibility and the role of the voluntary sector is a realistic option. He postulates that the persistent role of the state in health reflects widespread pessimism about the risk to which people could be exposed under a private system. However, he tends to agree with Green that the basis for these perceptions may not be strong. He suggests that if dissatisfaction with outcomes under current arrangements grows, public opinion may favour a reduced role for the government as a provider of hospital services before it would accept reduced state funding.

A shift to privately owned hospitals would appear to be very desirable. It is difficult to understand the ideological commitment to government ownership of bricks and mortar. Many of our health professional's problems can be attributed to the problems of working in a politicised system. The public good analysis provides no argument for such a policy. Some private hospitals might be for-profit, others non-profit, just as some insurance companies have been non-profit and others for-profit for many years.

If we also moved to put greater emphasis on private insurance, higher insurance premiums for higher risk people would give them an incentive to reduce risks by changing their lifestyles. Elements of co-insurance would reward the insured who avoided more expensive hospital care by an earlier visit to a GP.

Three questions about a system that relies more on private insurance must be answered. They concern the treatment of pre-existing conditions, those who cannot afford premiums, perhaps because they are already a high risk, and those who could have insured but did not.

- Those who are already ill with expensive conditions could be catered for as at present. That is, they would be state-funded and rationed through bureaucratic processes, although contracts for their care could be entered into with private providers.
- Those who could not afford premiums because of high risk relative to their incomes could have their premiums subsidised explicitly rather than implicitly as at present. However, it would be desirable that the subsidy was structured so as to give the recipients an incentive to increase their incomes and to make any lifestyle changes that would reduce their health risks.
- Those who could have insured but failed to do so and who failed to qualify for private charitable assistance would have to fall back on a minimum state safety net. They could be billed for the costs of services, perhaps with payment being a charge against future income. In hardship cases, rationing would have to be bureaucratically determined.

One of the most powerful reasons for relying more on private funding and insurance is that it would lead to far better decision making about the levels and types of health spending that people really want. At present we largely have to rely on voting for the alternative programmes offered by competing political parties. This is a very crude mechanism for establishing people's preferences. With lower taxes and greater after-tax income, most people could vote with their dollars, spending them either on out-of-pocket health expenditures or on insurance. Rather than having to argue whether or not 8 percent of gross domestic product (GDP) is the 'right' level of health spending, the answer would be determined by the aggregate decisions of individual citizens, just as it is for other essential services like food and housing. The political process could then be reserved for matters that need to be decided collectively, like public health and the state safety net.

Finally, let me anticipate the objection that the approach I have talked about would 'Americanise' the New Zealand health system. This is purely political posturing. There is much that is good about the quality of health care in the United States, but there is also much to avoid. To the best of my knowledge, no one advocates an American model for New Zealand. Its excesses stem from the unlimited demands on it that result from Medicare and Medicaid, the tax deductibility of insurance premia, and excessively defensive medicine. The last is the result of a tort system that denies the sanctity of contract and allows outlandish awards of damages for opportunistic claims. Nothing in these excesses makes greater reliance on private insurance unsound.

A reorientation of health policies along the lines I have been discussing was outlined in a report for the NZBR in 1991 by Sue Begg and Patricia Danzon on *Options for Health Care in New Zealand.*

As the aftermath of the collapse of the Soviet Union has demonstrated, there are many risks involved in dismantling a socialist system. We should see the problem of moving our schools and hospitals away from a politicised system in the same light. Half-hearted reforms that leave everything under state ownership and control and comprehensively suppress the price system are likely to produce disappointing outcomes. The accident compensation (ACC) reforms have gone further in breaking down the state monopoly, even though they leave in place a heavy regulatory regime, and we are already beginning to see very substantial gains.

It is no surprise that the health reforms to date have caused so much frustration for so little gain. My purpose today has been to explain why the frustration that many in the health sector are experiencing is systemic. More money can paper over the cracks for a while, but it cannot alter the inevitability of rationing of expensive procedures and treatments, or the weaknesses inherent in a system that lacks the incentives and disciplines in the systems we use for meeting most of our other needs.

My main message is that we should stop looking across the pre-1989 Berlin Wall for our model of how to organise hospital care. Where private goods are involved, the standard mechanisms that we find in the private sector outperform political mechanisms in meeting the community's needs. And such an environment, in my view, would provide far more personal satisfaction for health professionals, and greater scope for them to be innovative and enterprising and see their human capital properly valued. It is the most promising escape route from the monkey's cage.

MISCELLANEOUS

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION TO THE MMP REVIEW COMMITTEE

JULY 2000

SUBMISSION TO THE MMP REVIEW COMMITTEE

Summary

- This submission to the MMP Review Committee (the Committee) is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily the chief executives of major New Zealand business firms. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.
- In this submission we strongly urge the Committee to support a further referendum on the electoral system, in accordance with item (c) of its terms of reference. Politicians and their parties have a strong self-interest in this issue and should not second-guess, pre-empt, obstruct or subvert the views of the public on electoral arrangements. There is a widespread public expectation of a further referendum.
- Specifically, we recommend the adoption of the same two-step procedure that was followed in September 1992 and November 1993:
  - In the first referendum voters would be asked: (A) if they want to retain the Mixed Member Proportional (MMP) system or change it; and (B) which of four alternatives – First-Past-the-Post (FPP), Preferential Voting (PV), Supplementary Member (SM), or Single Transferable Vote (STV) – they prefer;
  - If a majority vote for change in response to (A), a second referendum would be held. In this referendum voters would choose between MMP and the alternative in (B) that attracted the most support in the first referendum.
- This proposal is the most neutral *in relation to the original decision* that we can envisage. In 1993 it was deemed constitutionally appropriate to allow a simple majority of voters to determine the adoption of MMP, subject to provision for its future review. Given that background, we argue that a simple majority of those voting should determine the future of MMP *as part of the current review*.
- While we favour this approach in relation to the review of MMP because of the way it was introduced, we also recommend that major changes to longstanding and well-understood elements of New Zealand's constitutional arrangements should normally require a supra-majority of those voting, and perhaps confirmation in a second referendum held at least three years after the first. In our view it is highly desirable for the stability of government that a conservative approach is taken to proposals to amend proven constitutional arrangements.
- We believe that these recommendations provide for a democratic, fair and neutral process without bias in respect of past processes and future outcomes. We believe that there would be widespread suspicion of any recommendation by the Committee that looked to be defensive of present arrangements.
- While we believe our recommendation is neutral with respect to outcomes, our analysis is not. We agree with the body of opinion that believes MMP has been tried and found wanting in relation to FPP. We accept that some people prefer MMP on grounds of diversity of representation, but we question the magnitude of any such differences in the longer term. In any case, this should not be the primary consideration. We prefer FPP to MMP primarily on the criteria of accountability to voters, the ability to remove decisively governments that the electorate dislikes, and the likely quality of government decision making, particularly in a crisis. Although this view is not central to our recommendations which are focused on process, we think New Zealand is likely to be a more prosperous and cohesive country under FPP than under MMP.

1 Introduction

1.1 This submission to the MMP Review Committee (the Committee) is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily the chief executives of major New Zealand business firms. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 In this submission we focus solely on item (c) in the Committee's terms of reference. Item (c) is concerned with whether there should be a further referendum on changes to the electoral system. This focus reflects our view of its paramount importance for New Zealand.

1.3 Our interest in the issue of alternative voting systems for New Zealand is a longstanding one. In 1992 we commissioned a study of proposals for constitutional change in New Zealand from independent experts.[1] In this submission we are concerned only with the section of this study that analysed the issue of proportional representation.

1.4 In evaluating New Zealand's experience to date with the Mixed Member Proportional (MMP) electoral system, there is a need to ascertain the degree to which any good or bad experiences should be regarded as transitional or as indicative of fundamental features. For this reason our submission starts with a review in section 2 of the 1992 study's findings on the fundamental differences between MMP and First-Past-the-Post (FFP).

1.5 Section 3 uses this framework to review New Zealand's experience to date with MMP. Section 4 discusses the implications of this experience and section 5 presents our conclusions.

2 Review of the differences between MMP and FPP

2.1 In 1988 the eminent philosopher, Karl Popper, published an article in *The Economist* that explored the issue of how rulers or representatives should be chosen.[2] He proposed that a decisive test of any political system should be how well it allows an electorate to get rid of a bad government by voting it out of office. He pointed out that the system of coalition governments associated with proportional representation reduced accountability. On election day, no party may have been dismissed or appointed. A majority of voters might vote against a major party, only to find it still in a governing coalition. He also pointed out that proportional representation conferred a special status on parties – that is, on ideologies – that was not conferred by a Westminster system. This made (list) Members of Parliament (MPs) primarily responsible to their political parties. It deprived them of the freedom to exercise their judgment about what was in the best interests of the voters they represented and to whom they would be accountable under the Westminster system.

2.2 The 1992 report for the NZBR analysed, in chapter 3, the four alternatives to the Westminster system that were proposed at the time for New Zealand – preferential voting, the single transferable vote, mixed member proportional systems, and supplementary systems. It concluded that the single transferable vote system should be rejected on the grounds that it appeared to have unambiguously negative consequences for the community. While preferential voting was a safe choice, its

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1 *An Analysis of Proposals for Constitutional Change in New Zealand* by Penelope Brook Cowen, CS First Boston, Tyler Cowen, George Mason University, Alexander Tabarrock, George Mason University, with a foreword by Richard Epstein, University of Chicago, New Zealand Business Roundtable, September 1992.

2 'The Open Society and its Enemies Revisited', *The Economist*, 23 April, 1988, pp 25–28.

virtues did not appear to be sufficient to warrant a change from FPP. Turning to supplementary systems, the study found that these would complicate the FPP system without necessarily satisfying those seeking the virtues of proportional representation. The authors therefore focused on MMP as an alternative to FPP.

2.3 We summarise the primary differences they identified between MMP and Westminster-FPP systems as follows:[3]

- MMP and Westminster systems differ in their underlying concept of democracy. Proportional systems attach primary importance to ensuring that representative *processes* drive parliament's decisions. (In MMP the prime consideration is the proportionality of political *parties* in the composition of parliament.) In contrast, the Westminster system can be seen as satisfying a requirement that the *outcomes* of parliament's decisions should meet the needs of the representative (median[4]) voter.[5] Political parties get no specific recognition;
- Westminster systems have the effect of pushing political parties who seriously desire parliamentary representation to the middle of the political spectrum (ie towards the median voter). MMP leads to greater ideological differentiation amongst parliamentary parties;
- MMP encourages greater proliferation of minor parties in parliament;
- politicians are less accountable to voters and more accountable to the parties making up a governing coalition under MMP;
- politicians are under less pressure to maintain appeal to the median voter under MMP and are under more pressure to conform with the views of their political colleagues;
- there is likely to be greater separation of powers between the executive and the legislature under MMP; and
- the stability of MMP systems may depend on limiting the representation of minor parties.

2.4 In respect of the first point, the study observed that Westminster systems are consonant with the notions of accountability and clear demarcation of power. Because FPP systems usually lead to a one-party government, voters commonly determine directly who can form a government and know exactly which party to hold to account for the government's decisions.

2.5 The need for the major parties to be 'broad churches' of opinion under FPP forces these parties, when in government, to take decisions that are intended to produce outcomes that should generally satisfy the preferences of the representative or median voter. This is why FPP is characterised as a system for producing *representative outcomes* in contrast to proportional systems that ensure *representative (parliamentary) processes*.

2.6 On balance the independent experts we commissioned did not favour the MMP system for New Zealand for the following main reasons:[6]

- MMP may allow minority interests to obtain undue power. In this sense it risks being less democratic and less representative;

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3 Refer to pages 3.23 and 3.24 in the study.

4 They define the median voter as the voter who stands in the middle of the spectrum. This can be thought of in relation to gender, age, race, religion or other characteristics.

5 The argument is that under FPP only parties that have a broad-based appeal to the population at large (ie to the median voter) can expect to form a government.

6 For a fuller, verbatim summary of the conclusions, see the appendix.

- MMP can make governments less accountable to voters because of the greater frequency of coalition governments. Post-election coalition negotiations are contrary to democratic principles because they undermine accountability for pre-election promises;
- MMP confers power over individual MPs to parties at the expense of the power enjoyed by voters; and
- MMP systems arguably tend to disenfranchise the large and apparently irreducible proportion of voters who fail to understand that only the party vote counts for party representation.

2.7 A more recent commentary by the legal scholar Richard Epstein has added to these reflections. He questioned the likely policy stability and coherence under MMP compared to FPP:

> Often there is no convergence to the centre under proportional representation. There are inconsistent policies involving an uneasy alliance between ministers from Party A, representing issues the general public cares about, and ministers from Party B, representing issues that only a fraction of the public cares deeply about. These difficulties make it more difficult for the government as a whole to operate coherently on many issues.[7]

In this commentary Epstein also questioned the relative stability of governments between scheduled elections under MMP: "If a coalition is built to handle problem A, and then problem B surfaces, the coalition may fall apart".[8] This could be a disconcerting factor for those trying to plan irreversible investments or make spending decisions. He also noted that it was desirable for a government to be able to speak with a single clear voice at times of crisis or when dealing with matters of international significance. (For example, it is clearly undesirable for one senior coalition member to be seeking to maintain international investor confidence in New Zealand while others are raising concerns about foreign investment, the future of the Reserve Bank of New Zealand Act 1989 or respect for the sanctity of contracts in New Zealand.)

2.8 Epstein observed that the distinction MMP introduces between list MPs and constituency MPs is bound to prove troublesome.[9] He also pointed out that virtually everything in an electoral system influences everything else. For example, a system that is more prone to the tensions associated with coalition governments could well increase the ability of bureaucracies to run their own agendas.

2.9 Section 3 draws on these perspectives in reviewing New Zealand's experience with MMP since the first MMP election in 1996.

3 New Zealand's experience to date with MMP

3.1 ***The 1996 election.*** Few would dispute that MMP got off to an unsatisfactory and embittered start in 1996.

3.2 First, the aftermath of that election demonstrated with a vengeance that the electorate had lost the ability to determine who would form a government.

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7 See p 17 in *MMP: The Right Decision?*, Richard Epstein, (1999), New Zealand Business Roundtable, Wellington.

8 Richard Epstein, *op cit*, p 11.

9 Richard Epstein, *op cit*, pp 11–13. The difficulty with MPs who resign from their parties illustrates this point.

3.3 Second, New Zealand First's much-delayed decision to form a coalition with National was also consistent with the study's prediction that MMP would tend to undermine the value of pre-election promises. (New Zealand First had campaigned in good part on the slogan that a vote for New Zealand First was the only way voters could keep National out of power.)

3.4 Third, the experience amply demonstrated how decisively MMP could hand disproportionate power to a minor party. New Zealand First extracted from National: (i) a promise to raise government spending (of dubious value) by $5 billion over three years;[10] (ii) the position of Treasurer for its leader, a person who had no previous experience in the finance portfolio and could not have been expected by the dominant party to gain readily the respect and confidence of the commercial community; and (iii) disproportionate representation in cabinet for its members, even without taking into account their lack of experience and qualifications.

3.5 Fourth, the election result demonstrated that MMP could also be unfair to minor parties that were around the 5 percent mark. The Christian Coalition scored just below the 5 percent mark, which was a crippling blow to its fortunes.[11]

3.6 The public's distaste for these events is amply indicated by the movement in the monthly opinion polls at the time recording public support for MMP. After trailing support for MMP for a long time, support for FPP moved 4 percentage points ahead (42 percent to 38 percent) in November 1996. By April 1997 this margin had increased to 22 percentage points (53 percent to 31 percent).[12]

3.7 Most of these lessons illustrate features of MMP that can be expected to be permanent. The elements that could plausibly be argued to be transitional include:

- the time it took to form the coalition;
- the degree to which the major parties handed bargaining power to the minor party and the degree to which the minor party was prepared to frustrate its supporters and be seen to be conducting an auction;
- the depth of the anger and the deep sense of betrayal at the outcome both amongst parliamentarians and amongst New Zealand First voters;[13] and
- the level of inexperience amongst New Zealand First's cabinet ministers.[14]

3.8 ***Other features of the 1996–99 experience***. Debate about the probity of the selections and rankings of candidates for the party list was also a feature of this period. The party list system is an inextricable feature of MMP and seems likely to be an ongoing source of suspicion and distrust within political parties. Of course, candidate selection processes can also be contentious under FPP, particularly as between the preferences of the party as a whole and the local electorate. However, it is undeniable that MMP reduces the power of voters to have the last say

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10 As the New Zealand Manufacturers' Federation pointed out at the time, much of this spending appeared to be likely to transfer wealth in favour of the relatively well off.

11 Arguably this rule would be less crippling if the rules governing the access of public parties to radio and television were less biased in favour of parties enjoying parliamentary representation. (This comment refers to the allocations of media time and taxpayer funding and to section 70 of the Broadcasting Act 1989 that significantly limits parties in spending their own funds to buy radio or television time.) However, this is an issue that is common to MMP and FPP.

12 See p 173 in 'Why MMP Must Go', by Graeme Hunt, *National Business Review*, 1998.

13 The argument that this is transitional may depend on the unhappy assumption that in future the electorate will be more cynical about its electoral system.

14 The first election under MMP is likely to introduce minority parties to parliament for the first time.

candidate by candidate, and that it undesirably increases the power of those controlling the party.

3.9 Arguably, the first MMP election was consistent with the view that MMP would lead to greater ideological divisions between the parties represented in parliament. The Alliance increased its representation and ACT appeared in parliament for the first time.

3.10 Events also provided support for the view that under MMP individual politicians would see less need to appeal to the median voter. For example, a subset of New Zealand First's members of parliament[15] appeared to be committed to achieving benefits for a minority of New Zealanders – implying that the needs of the median voter were not their paramount concern. (However, this subset did not survive the 1999 general election. Arguably the jury remains out on the issue of whether any party based on minority views about race, gender or religion can obtain and sustain parliamentary representation under MMP.)

3.11 Instability in the coalition government was another feature of this period. It can be difficult for a minority party in a coalition to maintain a safe margin above the 5 percent level when a coalition government finds itself having to take hard decisions that affront sections of popular opinion and/or offend more and more interest groups. The pressure on the minority party to find ways of distinguishing itself from its dominant partner in the public mind is clearly a threat to both the unity of the minority party and that of the coalition government. It also adversely affects perceptions about the cohesion and stability of government policies.

3.12 While parliamentary processes coped with the multiple transitions during this period from majority coalition government to a minority single-party government, in our view the whole experience was seriously negative for the quality of policy making. Individual members of parliament who would never have been endorsed by the electorate under FPP were able to exercise hold-up authority over the government to an extraordinary degree. Some apparently felt no need to limit the use of their power to the pursuit of the national interest.

3.13 As explained in section 2, there are grounds for surmising that the quality of policy making is likely to be generally worse under MMP. Certainly, it was woeful under the first MMP government. The fiscal position deteriorated markedly. Poor quality spending increases undermined the country's ability to make the tax cuts that are highly desirable if New Zealand is to be internationally competitive. New Zealand's international commercial standing suffered visibly. For example, the rising trend in New Zealand's rating for its sovereign debt was reversed. The rate of unemployment stopped falling. Arguably, the government's passivity about unemployment in the face of the job-destroying decisions by the Employment Court reflected in part the difficulties of MMP government. New Zealand experience confirmed concerns about paralysis in decision making associated with proportional systems. Gains built up can quickly be lost, especially as competitor economies, not shackled by an electoral system such as MMP, continue to make gains.

3.14 Another feature of this first experience with MMP that caused widespread concern was the frequency with which parliamentarians left the parties that had got them into parliament yet stayed on as independents, joined an existing party, or formed a new party. This issue is more controversial under MMP because list MPs can make no claim to having been personally endorsed by the electorate. Yet any solution to this problem is likely to strengthen the power of political parties. As Karl Popper argued (see paragraph 2.1), this transfer of power tends to weaken the power of

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15 The self-styled 'tight five'.

voters and conflicts with the ethos of the Westminster system which holds parliamentarians responsible to their electorates, not their parties.

3.15 ***Dramatic shift in public opinion.*** The immediate shift in public opinion against MMP in November 1996 and the sustained preference for FPP since that date also suggest that the general public see New Zealand's experience of MMP as an indictment of MMP itself. This interpretation is supported by more detailed polling of changes in public opinion about MMP. Opinion polls between 1993 and 1997 revealed marked declines in the proportion of respondents who believed that MMP would improve the representation of minorities, produce more consensus in decision making, make it harder to introduce unpopular policies such as asset sales, produce a higher quality of MPs or improve MPs' behaviour.[16]

3.16 ***The 1999 election and its aftermath***. The process of government formation was less prolonged and less divisive than in 1996. Even so, the eventual outcome was messy. The delay in determining the number of seats won by the Green Party meant that it could not participate in the coalition negotiations. This experience confirms that the shift in the balance of power in favour of minor parties can cause inequities between the minor parties.[17]

3.17 The new government has demonstrated that radical and far-reaching measures can be quickly pushed through select committee processes and parliament under MMP. It has appealed to its election 'mandate' and has had little regard to expressions of concern about its policies or seen a need to justify them with policy papers. The hopes of greater deliberation and consensus over new legislation held by advocates of MMP have not been realised.

3.18 The minor party in the new coalition government has already slipped markedly in the public opinion polls, leading to speculation as to how it will address that problem. Particularly in the light of the breakdown of the first coalition government under MMP, this can be expected to raise doubts in investors' minds as to the stability of the coalition.

3.19 The finding in the NZBR study that many voters would not be able to understand proportional voting systems appears to have been being validated by New Zealand's experience under MMP to date. The Electoral Commission has reported that public understanding of MMP during the 1999 election was generally lower than during the 1996 general election. Only 76 percent of people knew they had two votes compared with 79 percent in 1996.[18]

3.20 The experience with MMP to date has also dashed some other hopes for that system. Few would argue, for example, that MPs' behaviour in parliament has improved. Indeed, there is an argument that MMP will lead to worse behaviour by minor parties that have slipped in opinion polls below the 5 percent threshold and are desperate for publicity.[19] The hope that MMP would put an end to breaches of manifesto promises has not been fulfilled. One tendency has been for parties to be less explicit in their commitments, which arguably reduces accountability.

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16 Graeme Hunt *op cit*, p 171–73.

17 Supporters of MMP would argue that the system greatly reduces the inequities between minor and major parties in terms of the relation between the proportion of votes and the proportion of seats.

18 *The Press*, 11 May, 2000.

19 See the article by John Armstrong, political editor, *New Zealand Herald*, 8 July, 2000.

4 Implications

4.1 New Zealand's experience to date with MMP accords with the assessment of our study of the implications of the fundamental differences between MMP and FPP. We therefore discount heavily any suggestion that New Zealand's unfavourable experiences up until now with MMP are largely transitional. The analysis in section 3 found some elements that could be transitional, but they are not so material as to affect the overall conclusion.

4.2 In our view the New Zealand experience with MMP provides strong support for the view that it is unwise, as a general rule, to change longstanding, proven constitutional arrangements by a simple majority vote. In-depth polling of a sample of those who voted for MMP on 6 November, 1993 indicated that many people were seizing the opportunity to protest about the politicians and political decisions of the day rather than to express a clear preference between voting systems. Specifically, pollsters found that only 32 percent of those who voted for MMP said they did so mainly because they were 'positively convinced' that it was a better voting system.[20] Given that 85.2 percent of registered voters voted and that, of these, only 53.9 percent voted for MMP, this implies that only 15 percent of the electorate voted in favour of MMP in 1993 *primarily* because they thought it was a better system. This figure rises to 25 percent of the electorate if we include the additional 22 percent of those who voted for MMP both because they were positively convinced it was a better system and because they were unhappy with politicians.[21] These are extraordinarily low proportions in favour of the adoption of such a controversial and far-reaching change.

4.3 Nor can any comfort be derived from asking how well-informed were the views of those who were 'positively convinced' in either direction in 1993. It is noteworthy, for example, that the 'benefits' listed in paragraph 3.15 that voters mentioned to pollsters as reasons for favouring MMP bear little relation to the issues that authorities on electoral systems believe are of major relevance to the choice. These include:

- which system allows the electorate to get rid of governments they dislike most readily?[22]
- is it more desirable for an MP to be primarily responsible to a political party – that is, to a particular ideology – rather than to a group of voters who have elected the MP to represent their interests?
- are voting systems that produce complex, unstable governments desirable?
- is a 'fairer' representation in parliament better if it gives undue political power to minority parties?
- do coalition governments reduce accountability, and is this desirable?
- are those controlling party machines more likely to select candidates that are representative of the interests of the electorate if each and every candidate does not have to be voted in by the electorate?

If voters in 1993 were not particularly well-informed on these issues (as the responses to polls may indicate), this may provide a more fundamental explanation for the volatility through time of the views of the public about the choice between MMP and FPP.

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20 Graeme Hunt, *op cit*, p 171.

21 The only other major category, at 41 percent of respondents, was for voters for MMP who said that they did so primarily because they were unhappy with politicians.

22 Those who voted for New Zealand First in 1996 in order to 'get rid of National' may have clear views about the answer to this question.

4.4 The lesson we take from the volatility of polls of public opinion is that responses can be heavily influenced by extraneous factors. The original support for MMP was clearly bolstered by a desire to use it as a vehicle for registering a protest vote against FPP-elected politicians and political parties. This implies that the subsequent fall-off in surveyed support for MMP should be interpreted as reflecting (in unknown proportions) a decline in the protest element of support and a reassessment of MMP as a voting system.

4.5 For these reasons our main conclusion and submission is that there should be a further referendum to allow New Zealanders to express a considered view on MMP. This should be the main outcome of the Committee's review. The electorate, not parliamentarians, must determine the future of MMP in New Zealand. Politicians who owe their presence in parliament to the MMP system should not pre-empt public opinion on this issue. Politicians have an overwhelming conflict of interest that must be acknowledged and handled with integrity. In our view this means that they must not be seen to be taking the decision out of the hands of the public.

4.6 In the interests of fairness to all viewpoints, we believe that the process that should be followed in setting up a referendum should be identical – to the greatest extent feasible – to the process that brought in MMP. Specifically, we believe there should be a two-stage referendum conducted on the same lines as the previous one, and on the basis of a simple majority vote. We do not believe that changes to important constitutional arrangements should normally be made without a supra-majority requirement being met (and we think this was a flaw in the earlier decision), but it would be highly undemocratic for parliament to change the rules for a repeat referendum. However, the Committee might give consideration to the case for supra-majority requirements for other changes to constitutional arrangements. There may even be an argument for requiring confirmation of major constitutional changes by a subsequent referendum held, say, three years after the first so that people can reflect on the issue.[23]

4.7 Our belief that the electorate should be given the opportunity to confirm or reject MMP is strengthened by the result of the 1999 referendum on the number of MPs. Voters overwhelmingly endorsed the citizens-initiated referendum to reduce the size of parliament to 99 members. We believe that parliament should respect this verdict. It is difficult to recall any government that has been more insistent than the present coalition government that policies allegedly endorsed by the electorate should be implemented. There can be no debate about what the electorate endorsed on the issue of the number of MPs. Implementing a reduction in the size of parliament would require significant changes to current MMP arrangements. It therefore makes sense for a referendum to be held that would allow both issues to be considered in a coherent manner.

4.8 We are unconvinced by a range of arguments that have been advanced for disregarding the clear outcome of the referendum on the size of parliament. The notion that more MPs must result in a better average quality of MP or in better quality decisions seems naive. More MPs could result simply in a more mediocre government. Similarly, the argument that MPs in cabinet will comprise a higher proportion of all MPs with a smaller parliament depends on the size of cabinet, and we believe there is a good case for a smaller cabinet. In any event, it is the proportion of government MPs to all MPs that decisively limits the ability of the executive to dominate the legislature. Finally, we doubt that the quality of select committee deliberations bears any simple relationship to the number of MPs.

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23 See Richard Epstein, *op cit*, p 16.

5 Conclusion

5.1 Given our view that MMP has confirmed many of the criticisms made of it and disappointed many of the hopes of its proponents, we consider the electorate should have the opportunity to express another verdict on it. Accordingly, our submission has concentrated on the process that should be followed to give the electorate this opportunity. In our view the select committee should recommend a form of referendum that poses the choices in a neutral manner, taking account of the public's expressed desire for a smaller parliament and any other amendments to the Electoral Act 1993 that might need to be made.

5.2 We do not believe it should be the role of the select committee to make judgments about the merits of alternative electoral arrangements, although individual parties and politicians should be free to do so. For that reason we do not see this submission or the select committee hearings as the place to litigate this issue. Nevertheless, we agree with the body of opinion that believes MMP has been tried and found wanting in relation to FPP. We accept that some people prefer MMP on grounds of diversity of representation but we question the importance of any such differences in the longer term, and we believe the arguments in favour of MMP are outweighed by the more fundamental ones about the nature of a sound democratic system. In our view, New Zealand's previous Westminister system, or variants of it such as preferential voting, have greater merit. We note that the Labour Party in Britain appears to be backing off plans to introduce a form of proportional representation and that in recent years there have been moves and attempts in Italy and Japan, two countries that have been paralysed in their decision-making processes, to make their electoral systems less proportional. In view of the advantages as we see them of FPP, we would be happy for the electorate to be given a straight choice between MMP and FFP. However, in fairness to other views and for reasons of due process, we believe the referendum question should be posed in the same way as on the previous occasion.

5.3 Accordingly we recommend that the Committee should decide that:

- the pending review of the MMP system should be determined by binding public referenda:
  - In the first referendum voters would be asked: (A) if they want to retain MMP or change it: and (B) which of four alternatives – first-past-the-post, preferential voting, supplementary member, or single transferable vote – they prefer.
  - If a majority vote for change in response to (A), a second referendum would be held. In this referendum voters would choose between MMP and the alternative in (B) that attracted the most support in the first referendum.

5.4 We also suggest that the Committee give serious consideration to recommending that major changes to New Zealand's constitutional arrangements should in future normally require a supra-majority amongst those voting, and perhaps a subsequent referendum (say three years later) to confirm that decision.

APPENDIX

Conclusions in Relation to MMP[24]

The most serious of the four options under consideration is the mixed-member proportional system, used in Germany. This system would offer parliamentary representation for smaller parties and make coalition governments likely. Experience on the European continent with the mixed-member system (and assorted variants) illustrates that this form of proportional representation is a viable and stable form of government.

The mixed-member proportional system would offer some advantages over current institutions. Specifically, the necessity of assembling and maintaining a coalition government places checks upon governmental powers and allows greater representation for minorities. Furthermore, the process of government is made more representative in the sense that a greater number of different opinions can be heard in the legislative chamber.

Nonetheless, we do not favour the mixed-member proportional system for New Zealand. Under this system, minority interests may hold the ability to extract excessive policy concessions from a government and obtain undue power. In Germany, for instance, the sentiments of the Free Democratic Party (FDP, a minority party that usually wins between five and ten percent of the vote), determine which of the two major parties will come to power. The decision of the FDP concerning which coalition to create supersedes much of the voters' influence. In this sense coalition governments and proportional representation are less democratic and less representative.

Furthermore, government becomes less accountable to voters when coalition formation is present. Voters are never sure which party is responsible for which decision and voters can never decisively turn a party or government out of power. We see the negotiation of coalitions after an election as contrary to democratic principles. Promise-breaking is institutionalised and the influence of party machines increases. In addition, under the mixed-member system political parties could obtain even more power by controlling the process of candidate nomination.

The mixed-member system also complicates the electoral mechanism and is not understood by many voters. Even in Germany, a well-educated country where the system has been used for many years, the workings of the system are not well understood.

More generally, we do not favour the mixed-member system because we expect the Westminster system to perform reasonably well in the future, provided that New Zealand remains an open economy. Changing the electoral mechanism would increase policy uncertainty and affect the workings of government in an uncertain manner without a strong presumption in favour of improvement.

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[24] Extracted from Cowen *et al*, *op cit*, chapter 3, *An Analysis of Proposals for Constitutional Change in New Zealand*.

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION TO THE FOREIGN AFFAIRS, DEFENCE AND TRADE COMMITTEE

INQUIRY INTO NEW ZEALAND'S ECONOMIC AND TRADE RELATIONSHIP WITH AUSTRALIA

JUNE 2000

SUBMISSION TO THE FOREIGN AFFAIRS, DEFENCE AND TRADE COMMITTEE : INQUIRY INTO NEW ZEALAND'S ECONOMIC AND TRADE RELATIONSHIP WITH AUSTRALIA

Summary

- This submission to the Foreign Affairs, Defence and Trade Committee is made by the New Zealand Business Roundtable (NZBR), an organisation consisting primarily of chief executives of major New Zealand businesses. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.
- Closer Economic Relations (CER) has, without doubt, been of significant benefit to New Zealand.
- There are, however, a number of outstanding areas for reform. Priorities include removing the restrictions on the free flow of capital and the remaining exemptions for goods and services.
- More broadly, New Zealand should actively explore developing similar relationships with other countries, either on a bilateral or, preferably, a multilateral basis.
- New Zealand should resist the temptation to extend subsidies and protection to its industries just because Australia or any other country does. The reason for this suggestion is that, such assistance is likely to penalise, rather than benefit, the economy as a whole.
- Harmonisation of New Zealand's domestic policies with Australia's policies should be considered on a case-by-case basis. Our aim should be to have the best possible public policies, rather than necessarily replicating the policies of another country.
- We welcome research and debate on the merits of adopting the currency of another country. For a common currency to work effectively – eg without leading to additional volatility in unemployment – New Zealand would need flexible labour markets. The direction of current policy, however, is to reduce rather than increase the flexibility of New Zealand's labour markets.
- Consideration should be given to removing passport restrictions on trans-Tasman travel. There are likely to be more cost-effective ways of restricting drug trafficking.
- Local content quotas are likely to stifle rather than encourage innovation and vitality in our media, advertising and broadcasting industries.
- Political union with Australia is not a matter on which the NZBR has a view. However, it would be a mistake to expect significant economic benefits from any such move. As the case of Tasmania demonstrates amply, political union is no 'silver bullet'.
- At the end of the day, New Zealand's economic success is in our own hands. The economic performance of countries like Switzerland, Singapore and Hong Kong shows that size is no handicap. How well we do depends mainly on how well we manage our own affairs.

Strategic overview

Around the world, countries' economies have become more closely integrated in the last half-century. The volume of world merchandise trade today is more than 16 times the volume of 1950, a rate of growth three times faster than the growth of global output.[1]

This growth in trade has brought huge economic gains. A recent paper in the *American Economic Review* estimates that every 1 percentage point increase in the ratio of trade to gross domestic product (GDP) raises income per person by between one-half and 2 percent.[2] Similarly, the Organisation for Economic Cooperation and Development (OECD) estimates that nations that are relatively open to trade grow about twice as fast as those that are relatively closed.[3]

Both New Zealand and Australia were relative latecomers amongst OECD countries to the phenomenon of economic integration. The two governments took little part in the regional and multilateral agreements through which other OECD countries became more closely integrated with each other and the rest of the world in the four decades following the end of the Second World War.

In the past two decades, however, both countries have moved a long way towards more liberal trade and investment regimes. The initial CER agreement provided a platform on which both countries have built.

The NZBR strongly supports more outward looking policies. We welcome the steps that have been taken to expose New Zealand industries to competition from the rest of the world. This competition has provided a necessary spur for New Zealand businesses to innovate, to reduce costs and to make products that the customer wants.

The decision of the new government to halt the phasing out of tariffs is of major concern and marks a significant policy reversal.

Rather than slowing down the process of liberalisation, we consider that there are a number of further initiatives the government should be taking. Priorities include:

- removing all remaining tariffs by a fixed and early date;
- treating anti-dumping actions as part of normal competition law;
- reducing, rather than increasing, official assistance for exports;
- removing the remaining monopsony rights of the three marketing producer boards;
- increasing the scope for private foreign direct investment in New Zealand, including in state-owned enterprises; and
- seeking opportunities for regional and multilateral liberalisation.[4]

Immigration policy raises further important issues. There is no sound reason for thinking that higher inflows would increase economy-wide unemployment rates.[5] While immigrants produce, they also consume ("every pair of hands comes with a mouth") and their

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1 OECD, (1998), 'Open Markets Matter: The Benefits of Trade and Investment Liberalisation', Paris, 1998, p 25.

2 Frankel, Jeffrey A and Romer, David, 'Does Trade Cause Growth', *American Economic Review*, 89/3, 1999, pp 379–399.

3 OECD, *op cit*, p 10.

4 Henderson, David (1997), *New Zealand's External Economic Policies, Current Issues in an International and Trans-Tasman Perspective*, New Zealand Business Roundtable, Wellington.

5 As Henderson, *op cit,* 1997, p 24 notes, the best evidence in recent decades that increased immigration does not increase unemployment is that the United States, with a much faster rate of growth of its labour force, largely as a result of higher immigration, has experienced and maintained significantly lower rates of unemployment than the countries of continental Europe.

additional demand leads to additional jobs. There are good reasons to believe a more open immigration policy would make for somewhat greater national prosperity and would have wider positive rather than negative social effects.

The impact of CER

The benefits of CER are indisputable and do not need to be extensively documented here.[6] Since CER was signed in 1983, bilateral trade has grown from NZ$2.6 billion to NZ $9.8 billion in June 1998 in current dollars. Australia has become New Zealand's largest export market and New Zealand has become Australia's third largest export market. We are each other's largest market for manufactured goods.

Amongst other things, CER has:

- facilitated trade and economic links between New Zealand and Australia;
- improved resource allocation, providing better signals for investment decisions in both economies, to our mutual advantage; and
- provided a platform for wider liberalisation.

Fifteen years ago, the manufacturing industry in New Zealand could not contemplate the idea of dismantling import licensing against Australia by 1995. Now, New Zealand companies are able to compete internationally without assistance.

There is no question that CER has helped lift New Zealand's economic performance. Competition forces industries to become more efficient. Through CER, New Zealand companies learned to compete with Australian ones first. As a former chairman of the NZBR noted, "The whole purpose of CER was to help each country break out of its cocoon and tackle the wider world".[7]

It is worth reflecting on the condition the New Zealand economy would be in now if we had not headed down the path of integration with the rest of the world that was begun with those first cautious steps. The experiences in the mid-twentieth century of Argentina and Uruguay – two once rich countries that stagnated after adopting populist and closed economic strategies – illustrate well the implications for New Zealand if we had continued with 'Fortress New Zealand' policies.

Further development of CER

The CER agreement of 1981 covered trade in goods only. This initial agreement was extended, in 1988, to cover services. The Trans-Tasman Mutual Recognition Agreement (TTMRA), which was signed in June 1996, covers mutual recognition of goods and occupations across the state and national jurisdictions. Also, in 1996, the Australian New Zealand Food Authority was established to develop common food standards.

Remaining tasks within the New Zealand/Australia relationship include:

- removing New Zealand's two remaining exceptions for goods and services (coastal shipping and air traffic control services). There is no reason to treat these sub-sectors differently and shelter them from international competition. Such special protection raises the costs for other parts of the New Zealand economy;

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6 For an overview, see 'Impact of CER', (Australian) Bureau of Industry Economics, 1995 and 'CER: Economic Trends and Linkages' by Sir Frank Holmes and Stephen Edwards, Institute of Policy Studies and National Bank of New Zealand, 1994.

7 Myers, Douglas, 'Australia and New Zealand – A New Economic Partnership?', *The Economist*'s Fifth Roundtable with the Government of Australia, Canberra, October 1996.

- encouraging Australia to remove its remaining exceptions, including its exemptions for intrastate air travel, postal services and third party motor vehicle insurance;
- progressing mutual recognition of business and other laws as quickly as possible (including laws governing product labels and standards that may hinder free trade). Five goods (including motor vehicles, hazardous substances and industrial chemicals) remain outside the TTMRA, while West Australia still has not ratified the agreement; and
- extending the agreements covering movement of goods, services and labour to a counterpart agreement covering movements in capital also (see Investment Relationship below).

The aim should be full integration of the New Zealand and Australian economies into a single market.

At the same time we should be sure to protect the gains already made. Trans-Tasman shipping is one area where the benefits of liberalisation are under threat from potential changes to New Zealand's policies.[8]

Future directions and role of CER as a platform for other free trade agreements

Multilateral liberalisation is, for New Zealand, the first-best policy and the desired policy goal.

Bilateral or regional trade agreements that are open, outward and not a barrier to wider liberalisation are to be welcomed, both in their own right and as stepping stones towards the desired wider goal.

The establishment of a study group to look at a free trade agreement between the Asian Free Trade Agreement (AFTA) and CER was an encouraging step. Similar initiatives with the North American Free Trade Agreement (NAFTA) and Mercosur would also be welcome where the aim remains to achieve agreement without significant sectoral carve-outs.

New Zealand should continue to explore all avenues for bilateral, regional and multilateral liberalisation. Preferably this should be done in tandem with Australia but, if necessary, New Zealand should be prepared to go it alone.

The impact of the federal system on bilateral trade and economic relations

The Federal system in Australia is sometimes criticised for encouraging a range of special assistance measures (such as bounties, subsidies and 'active' industrial policies) at the state level.

As discussed in a recent paper, such 'assistance' policies are more likely to harm rather than help Australian industry overall.[9] They harm the economy by encouraging resources into subsidised sectors at the expense of unsubsidised sectors; by raising the overall tax burden on the economy; and by encouraging business people to spend time lobbying the government rather than focusing on their businesses.

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8 See New Zealand Business Roundtable and Federated Farmers, 'Ports and Shipping Reform in New Zealand, Current Development and Future Requirements', September 1989 and Swan Consultants, 'Reforming Trans-Tasman Shipping', a study commissioned by Australian and New Zealand business organisations, June 1992.

9 Kerr, R L, 'Hands-On, Hands-Off or Hand-Outs?', address to the Auckland Regional Chamber of Commerce and Industry World Trade Club Breakfast, 15 September, 1999.

Australia, like many other countries, is becoming increasingly aware of the cost of such 'active' industrial policies and is moving to lower industry assistance. With the exception of some highly protected sectors (motor vehicles, textiles, clothing and footwear), industry assistance in Australia is now at a level where it is unlikely to be a major factor in investment decision making.

World Trade Organization (WTO) obligations are also helping keep Australia 'honest', as evidenced by the recent case of Howe Leather where the WTO found that financial assistance from the Australian government was an illegal export subsidy.

However, regardless of the level of subsidies that the Australian government provides to its industries, the bottom line from New Zealand's point of view is that if Australia wishes to penalise its own overall economic competitiveness through such policies, that is Australia's folly. It certainly does not mean that New Zealand should follow suit.

We can try, through diplomatic and other means, to persuade Australia to reduce or eliminate subsidies to its domestic industries. Otherwise, we are better to get on with ensuring that our own domestic policies are sound.

Harmonisation of business, customs and tax laws

The NZBR supports *mutual recognition* of business and other laws between Australia and New Zealand.

Harmonisation of business and other laws should be considered on a case-by-case basis and should not be implemented for its own sake. New Zealand should strive to achieve the best possible public policies. Where Australia has the best policies we should be happy to adopt them. However, it does not make sense to adopt policies just because they are Australian. Where Australian laws impede trade and are in our view deficient, New Zealand could try to negotiate improved laws for both countries.

Getting our tax levels and tax structure right is vitally important. The first step is to control government expenditure so that only expenditures that add economic value or – in the case of social policies – are well targeted are undertaken. In terms of the tax structure, the key ingredients are to:

- achieve a low and flat income tax structure so that disincentives to work, save and invest are minimised; and
- get the general international tax regime 'right', because this impacts on the cost of capital for all New Zealand companies and their ability to compete internationally.

In respect of the international tax regime, one aim should be to reduce the tax burden on non-resident investors. New Zealand is a small economy. A tax on foreign capital just increases the cost of capital for New Zealand companies (because foreign investors require the same after-tax return that is achievable elsewhere in the world).

While the direction of reform in the international tax regime in recent years has been positive, we would urge the government to hasten the speed of reform.

Investment relationship

Unlike goods, services and labour, investment is not covered by CER or any other formal agreement between the two countries. As a leading Australian academic noted, the absence of a bilateral provision guaranteeing the free movement of capital is "the most glaring omission from CER".[10]

In contrast, the Treaty of Rome guarantees the "four freedoms" of movements of goods, services, capital and labour. NAFTA also has a chapter relating to foreign investment.

There have been some moves to lower effective restrictions on trans-Tasman investment flows in recent years (eg the raising in December 1999 of the threshold where approval is required for cross-border investment). However, regulatory approval is still required for investments above NZ$50 million in New Zealand and A$50 million in Australia.[11] These approval processes inevitably involve costs, delays and political risk.

Attempts to negotiate investment agreements at the multilateral level have had little success in recent years. The breakdown of the negotiations at the OECD on a Multilateral Agreement on Investment (MAI) is a prime example.[12] It may be that a bilateral agreement on investment with Australia would be more fruitful, if only to provide certainty that the current restrictions will not be increased over time.

The aim should be the free flow of investment between the two countries, just as we largely have a common labour market in the two countries.

Single trans-Tasman currency

The idea of New Zealand adopting another country's currency is not as radical as it may first appear. New Zealand once used the pound sterling and many countries now use the US dollar or Euro as their principal currency.

Several factors make the idea of currency blocs more plausible than it was 20 years ago, including low inflation rates and increasing trade in goods and services.

However, if a convincing case is to be made for changing the status quo, real advantages must be demonstrated. Areas of potential benefit include:

- reducing transactions costs (including the costs and risks of foreign exchange management);[13] and
- reducing firms' cost of capital.

These potential benefits must be weighed up against the possible costs including:

- the loss of one means of adjustment to adverse shocks that hit the economy. The fixing of the exchange rate to the US (or Australian) dollar means that other prices (especially wages) must carry more of the adjustment burden; and
- removing the exchange rate as one indicator of good or bad policy.

For there to be sustained ongoing benefits for New Zealand, we must meet the standard conditions for a currency union established by Mundell almost 40 years ago.[14] New

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10 Lloyd, P, 'Foreign Investment, Competition Policy and Labour Issues', CEDA/APEC Studies Centres of Australia, and New Zealand Roundtable Discussion of the CERTA, Melbourne, 30 April, 1997.

11 Both countries also have several sectors where special, more restrictive provisions apply.

12 See Henderson, David, (1999), *The Multilateral Agreement on Investment, A Story and Its Lessons*, New Zealand Business Roundtable, Wellington, for the reasons why the MAI foundered.

13 One recent study suggests that currency unions have a sizeable impact on trade. See Rose, Andrew K, 'Does a Currency Union Boost International Trade?', *California Management Review*, Vol 42, No 2, Winter 2000.

14 Mundell, Robert A, 'A Theory of Optimum Currency Areas', *American Economic Review*, 51, 1961, pp 509–517.

Zealand and the region whose currency we adopt should have a common or compatible fiscal policy and New Zealand would need to have flexible labour markets.

There is relatively free mobility of labour between New Zealand and Australia. However, if government policy makes our domestic labour markets less flexible, and we adopted a currency union with Australia, New Zealand would experience even greater migration to Australia at times of local economic downturns. Such migration would be unnecessary in a fundamental sense, because the expenses incurred would merely reflect the reduced labour market flexibility, not a rational response to basic economic conditions. If New Zealand were to adopt a currency union with a country with which we do not have open migration flows we would see increased volatility in unemployment in New Zealand.

Freedom of trans-Tasman travel

Residents of Australia and New Zealand are free to live and work in either country. Given the level of integration of the two economies, we question the need for passport controls between the two countries. Continental European countries no longer maintain passport controls for travel within the European Union. Removing the controls would reduce transaction costs for business travelers and tourists and allow border control resources to be directed to other areas.

While there are legitimate concerns about ensuring drug trafficking is restricted, there may well be better ways of achieving this objective.

Removing passport controls would require harmonisation between Australia and New Zealand of visa requirements with third countries. From New Zealand's perspective, removing passport controls would be more attractive if Australia relaxed its current policy of requiring visas from almost all other countries.

Cultural relationships

Maintaining a sense of national identity is important for all countries. Unfortunately, such a goal can be used as an excuse for protectionist measures in industries such as advertising, the news media and broadcasting.

It would not be sensible for New Zealand to go down a path of local content quotas. As well as being in conflict with our international obligations, imposing such quotas would lower rather than raise standards of quality, promote insularity and discourage a vibrant and innovative culture.

It is interesting to note that New Zealand's sport is becoming more rather than less integrated with Australia and the rest of the world. Recognising the importance of international competition, several of our sporting codes, like rugby league and soccer, have chosen to participate in Australia's domestic competitions as a means of bolstering local standards.

Conclusions

New Zealand has benefited considerably from CER and the liberalisation measures that followed it.

There are further steps that need to be taken, especially removing the restrictions on the free flow of capital and the remaining barriers to the free flow of goods, services and people.

Whether New Zealand should go further and consider political union with Australia is a political matter on which the NZBR has no view.

However, it would be wrong to believe that economic benefits would necessarily follow from any such political union. The 'poor-cousin' status of regions like Tasmania, the 'deep south' of the United States and southern Italy is more than ample evidence that political union does not automatically mean economic equality or success.

The economic performance of countries like Switzerland, Singapore and Hong Kong shows that size is no handicap in the economic success league. There are no silver bullets, however. How well we do depends on how well we manage our own affairs.

ROTARY CLUB OF WELLINGTON NORTH

OPTIMISM FOR THE NEW MILLENNIUM

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

WELLINGTON
9 DECEMBER 1999

OPTIMISM FOR THE NEW MILLENNIUM

In just over three weeks' time we shall be celebrating the dawn of the new millennium. I think we are on the verge of one of the most hopeful periods the world has ever seen. Indeed, I have felt that way ever since the fall of the Berlin Wall in 1989, surely the defining event of the last part of this century. As Bill Emmott, editor of *The Economist*, put it in a recent survey:

> The *fin* of this *siècle* has been an astonishingly positive period, far more positive than most people in the 1980s, and certainly the gloomy 1970s, would have thought possible. Liberty – political, economic and personal – has become a widespread fact for the first time. The threat of war casts its dark shadow over a smaller proportion of the world's population, and fewer people live in constant fear of arbitrary arrest, torture or worse. Too many still do. Nevertheless, Franklin Roosevelt's four freedoms – from fear and from want, and of belief and of expression – are possessed by more people, more securely, than ever before.

To be sure, all is far from the best in the best of all possible worlds. Millions of people still endure appallingly low living standards. There are still many unfree societies. Wars have erupted this decade in Bosnia, Rwanda, Kosovo, East Timor, Chechnya and many other places. Developments in technology bring risks as well as great opportunities. Governments continue to interfere in the lives of citizens in new and unwarranted ways. Human folly has not been eliminated and never will be.

But the bigger picture is surely one of hope. Democracy continues to spread around the globe. Hundreds of millions of people today are free from the yoke of communist totalitarianism under which they laboured just a decade or so ago. International tensions have subsided with the end of the Cold War. Social changes have seen vast improvements in the positions of women and minorities. Developments in computing and the internet are ushering in a new industrial revolution.

Taking a longer-term view reinforces the grounds for hope. The modern world began some 200 years ago with the first industrial revolution, driven by the growth of the rule of law, technology and the abandonment of the mercantilist system. Since then, ordinary people worldwide have come to enjoy living standards that were formerly the preserve of a privileged few. Average world per capita income in 1800 in today's money was US$100; by 1900 it was about $500; next year it will be about $5,000 and by the end of the next century some estimates put it to be in excess of $40,000, or higher than the average Western income of today. It could, of course, turn out to be much higher than even that.

The quality of life has improved in many other ways as well. Life expectancy has increased in rich and poor countries alike. Health standards have improved with advances in incomes, housing and medicine. The likelihood of a population explosion appears to be receding; indeed population decline may become a concern in some countries in the next century. The air and water in many advanced countries is becoming cleaner rather dirtier, natural resources are becoming less scarce rather than more scarce, and even any trend towards global warming appears manageable, with scientific estimates of the rate of climate change being downgraded steadily. The economist Julian Simon, who has done more than anyone to debunk the prophecies of environmental doom of the 1960s and 1970s, wrote in his last book:

> With reasonable surety one can expect that the material conditions of life will continue to get better for most people, in most countries, most of the time, indefinitely.

Along with the spread of democracy in the past 25 years there has been a profound change in the economic climate. The 1950s and 1960s were a golden age in the industrial world. Annual growth averaged 3–4 percent in many countries, inflation was negligible and 3 percent was considered a high rate of unemployment. All that changed in the 1970s with the emergence of 'stagflation' – stagnant growth coupled with high inflation and unemployment. There was much pessimism about the future of market economies.

From the mid-1970s, however, governments generally abandoned Keynesian economics and began to reverse earlier trends in policies. Many moved progressively towards policies of monetary and fiscal restraint and economic liberalisation. The result was that by the early 1990s inflation in the industrial countries had generally returned to low levels, and during the decade productivity and growth rates picked up. Unemployment has fallen in a number of countries, with the United States leading the way in returning to a state of close to full employment. The Asian crisis of 1997–98 seems likely to have been just a brief interruption to this trend. Parts of the advanced world look to be regaining the economic vitality of the 1950s and 1960s, and the prospects of a return to full employment in many countries over the next decade appear bright.

Many of the economic lessons of the past 25 years have been summed up in a book that has been on the *New York Times* best seller list for several months called *The Lexus and the Olive Tree,* written by the *Times*' chief foreign correspondent, Thomas Friedman. The book is about globalisation, and the theme is that in order to benefit from the new global economy a nation must play by certain rules that he calls the "Golden Straitjacket":

> . . . making the private sector the primary engine of its economic growth, maintaining a low rate of inflation and price stability, shrinking the size of its state bureaucracy, maintaining as close to a balanced budget as possible, if not a surplus, eliminating or lowering tariffs on imported goods, removing restrictions on foreign investment, getting rid of quotas and domestic monopolies, increasing exports, privatizing state-owned industries and utilities, deregulating capital markets, making its currency convertible, opening its industries, stock, and bond markets to direct foreign ownership and investment, deregulating its economy to promote as much domestic competition as possible, eliminating government corruption, subsidies and kickbacks as much as possible, opening its banking and telecommunications systems to private ownership and competition, and allowing its citizens to choose from an array of competing pension options and foreign-run pension and mutual funds.

"As your country puts on the Golden Straitjacket", Friedman writes, "two things tend to happen: your economy grows and your politics shrinks".

Friedman is no intellectual relation to Milton Friedman, Reagan or Thatcher; indeed he is an Al Gore Democrat and he shares some of Gore's wilder ideas on issues such as the environment. He is also conscious of the threats of globalisation to workers in protected industries and the cultural challenges it poses, as we saw last week in the responses of protesters on the streets of Seattle. But the book documents the net gains of trends toward liberalisation that need to be better explained by governments that wish to improve the living standards of their citizens.

Outside the economic arena, changes of thinking appear to be underway that are revising many of the approaches governments have taken to social problems since the 1930s. As always, the United States is the country to watch. Perhaps the major policy change presided over by the Clinton administrations of the 1990s has been the welfare reforms that have so far reduced by around half the number of Americans on welfare benefits. At first controversial, they now enjoy broad popular support. The combination of the strong US economy, very tight labour markets and the new stance on welfare has meant that unskilled and less educated workers have shared in the increase in real earnings, poverty rates have begun to decline, and even the bottom 20 percent of households have had a significant increase in their standard of living.

Similar lessons come from Asia. Singapore's senior minister, Lee Kuan Yew, noted in a speech earlier this year that from the late 1960s he had:

> . . . visited Hong Kong almost every year, to study and to understand why Hong Kong people work with so much more drive and vigour than the people in Singapore, and to learn something from them. They paid for their education, they paid for their medical services; the government owed them nothing and provided only law and order. They made their own housing in little shanty huts on the hillsides. They paid their way, and built modern Hong Kong.
>
> Through Hong Kong watching, I concluded that state welfare and subsidies blunted the individual's drive to succeed. I watched with amazement the ease with which Hong Kong workers adjusted their salaries upwards in boom times and downwards in recessions. I resolved to reverse course on the welfare policies which my party had inherited or copied from British Labour Party policies.

With few exceptions, Asian countries appear resolved not to go down the path of Western countries in creating large welfare states. Countries like New Zealand need to consider whether genuine compassion for the poor consists essentially of increases in welfare benefits or of a radically different strategy.

In other social areas such as health, education and retirement income, there are growing demands by voters worldwide to be able to decide how to spend their money rather than have politicians and bureaucrats make their choices for them. In the United States there is overwhelming support for junking the retirement income policy embodied in social security, the centrepiece of the New Deal. The state education monopoly is under attack as never before – American educational websites report new voucher schemes, charter schools and private non-profit and for-profit initiatives almost on a daily basis. These developments are replicated elsewhere and cannot fail to have an influence on New Zealand.

A common element of all these trends is a move away from a political society to a civil society, in both its commercial and non-commercial aspects. Politics is in decline worldwide. Casting a vote for a candidate or a political party is a terribly crude means of obtaining many of the things we all want in life. This is not, as some would have it, a retreat from community values – rather, it is a retreat from collectivist means. Again, for evidence look at the United States. Reports abound of talented young Americans giving time to help the less privileged, of wealthy business people retiring in their forties to devote their efforts to philanthropy, and even of some of the best college graduates choosing teaching as a career in the new educational establishments. In Gallop polls this year, 88 percent of adult Americans said that religion was either very important or fairly important in their lives, down surprisingly little from the 95 percent who made that claim in 1952.

The next development that will accelerate trends away from political society is the growth of the internet, which has been called the technology of freedom. It will increase vastly the spread of knowledge about better and worse ways of doing things. Financial capital and brainpower will move even faster from unattractive to attractive locations. E-business will further empower consumers and put pressure on firms operating anywhere in the world to deliver better, cheaper services. The internet will greatly limit the ability of governments to tax and regulate. In a 1997 article in *Wired* magazine, Jon Katz described the digital young, from Silicon Valley entrepreneurs to college students, as being disconnected from conventional political parties and having a nearly universal contempt for government's ability to work: they think it's "wasteful and clueless", not an instrument of positive change or social good. Governments that do not want their countries to become home merely to the unskilled, the immobile and the elderly will have to curb their interventionist impulses if they are to attract and retain mobile resources.

At the same time, lovers of civil society are not haters of governments undertaking their proper functions. The core functions of government are vitally important. Governments serve their citizens well when they protect property rights and enforce contracts, maintain a stable currency, ensure the provision of genuine public goods, keep markets open and provide a social safety net. It is when they move beyond those core roles that their tax, spending and regulatory policies become counterproductive and cause economies and societies to malfunction. A lesson of this century is that government failure is a far bigger problem than market failure. We need government, but we need smaller, better government.

Such ideas appear to be taking root in New Zealand, despite its legacy of "socialism without doctrines", the political history described in Michael Bassett's recent excellent book. The latest Massey University values study found that far more of the public see competition as good rather than harmful; most people favour private ownership rather than government ownership of businesses; more New Zealanders favour individuals looking after themselves, rather than the government doing it for them; and a whopping 92 percent have no confidence or not very much confidence in political parties. The authors state that:

> These items, and others as well, do *not* suggest a picture of a population far to the 'left', yearning for some extreme form of collectivism. It is in fact a picture of a society with a fairly strong preference for the freedom of the individual.

To be sure, there were some counter-observations and seemingly inconsistent responses, but the general thrust of these findings would have been unthinkable only 25 years ago.

Will the recent change of government in New Zealand interrupt the trends I have been describing? Time will tell. The Clinton administration in the United States and the Blair government in the United Kingdom did not fundamentally change the directions of the so -called Reagan and Thatcher revolutions; in most respects they carried them further. New Zealand is now lagging behind many of the current trends and we will lose further ground if we fail to press ahead or, worse, go back on recent achievements. To many New Zealanders, the proposals to restore a state monopoly in accident compensation, for example, must look like a triumph of outdated ideology over logic and experience. New Zealand can ill-afford such diversions, but equally it is unlikely to be able to ignore for long the lessons to which we will be exposed in a world that is not about to stop changing.

One should always temper an optimistic view about the future with caution. A salutary warning was given last year by an octogenarian Ronald Coase, a Nobel laureate in economics. Coase wrote:

> Having lived through World War I, World War II, the Great Depression, the emergence of communism in Russia and its spread (with the approval and active support of many intellectuals in the West), the triumph of Nazism in Germany (with the support of the great mass of the German people), the adoption of socialism in Britain, the horrors in countless countries all over the world in the post-war period (of which Bosnia is but a recent example), I find it difficult to ignore the role of stupidity in human affairs.

Thus despite the promising outlook, things could go terribly wrong. Follies also take less dramatic forms. Tasmania is an object lesson for New Zealand of how anti-business policies can turn a state or country into a depopulating economic museum. However, by and large I prefer the conclusion of another octogenarian and Nobel laureate, Milton Friedman, perhaps the most influential practitioner of economic ideas in the last 50 years.

Friedman ended his memoirs, published jointly last year with his wife Rose, with the following words:

> Judged by practice, we have been, despite some successes, mostly on the losing side. Judged by ideas, we have been on the winning side. The public in the United States has increasingly recognized that government is not the universal cure for all ills, that government measures taken with good intentions and for good purposes often, if not typically, go astray and do harm instead of good. The growth of government has come to a halt, and seems on the verge of declining as a fraction of the economy. We are in the mainstream of thought, not, as we were fifty years ago, members of a derided minority.
>
> So we close this book full of optimism for the future, in the belief that those ideas will prevail and that our children and grandchildren will live in a country that continues to advance rapidly in material and biological well-being and gives its citizens ever wider freedom to follow their own values and tastes, so long as they do not interfere with the ability of others to do the same.

As for me, I'm off with my family in three weeks' time to see in the new year in Jerusalem. Something happened there 2000 years ago which gave hope to the world in the centuries that followed. It seems like a suitable place on earth to think optimistic thoughts about the new millennium.

ARTICLE BY ROGER KERR FOR
THE INDEPENDENT

DOES THE VISIBLE OR THE INVISIBLE HAND EXPLAIN IRELAND'S ECONOMIC SUCCESS?

NOVEMBER 2000

DOES THE VISIBLE OR THE INVISIBLE HAND EXPLAIN IRELAND'S ECONOMIC SUCCESS?

The recent visit to New Zealand by Ireland's deputy prime minister, Mary Harney, must have been a disappointment to the *New Zealand Business Herald* and some industry lobbyists who have been advocating targeted industry policies for New Zealand.

Far from explaining Ireland's recent economic success – including an annual economic growth rate averaging nearly 7 percent during the 1990s – in these terms, Ms Harney described Ireland's policies in her address to an engineering industry audience in terms that were remarkably similar to the key features of New Zealand's post-1984 reforms. Interventionist strategies barely rated a mention.

New Zealand also achieved a 7 percent growth rate in 1993 and 1994 when its policies were in good shape. Since then it has failed to build on its earlier efforts and instead relapsed into high government spending habits. Ireland has kept moving forward: as Ms Harney puts it, sound policies "require time and patience and, above all, must be sustained".

Supporters of interventionist policies who have been calling Ireland the 'Celtic Tiger' ought to be more wary of the label given recent experience in Asia. Broadly, Asian economic success is a story of progressive economic liberalisation, but some Asian countries have stumbled because of misguided interventions. Japan's earlier economic advance was not due to the 'guidance' of Ministry of International Trade and Industry bureaucrats, and other East Asian countries have suffered from crony capitalism.

More importantly, standard economics tells us that selective industry policies distort resource allocation and reduce growth, and that governments are poor at picking industry winners. Ireland pursued many such policies in the 1970s and 1980s, but its economic performance was disappointing. The turnaround came with the adoption of a more orthodox policy approach.

New Zealand's recent policies have often been described in terms of five fundamental 'pillars': fiscal discipline, a low-rate broad-based tax system, monetary stability, an open economy and flexible labour markets. How does Ireland's approach compare?

- Ireland has achieved an extraordinary transformation in its public finances. Most dramatically, the ratio of government spending to gross domestic product (GDP) has come down from 51 percent of GDP in 1986 to a projected 32 percent next year (the comparable figure for New Zealand is around 40 percent). This shift in the true tax burden is unparalleled in the countries that belong to the Organisation for Economic Cooperation and Development (OECD). Budget surpluses are running at around 3 percent of GDP.
- In line with a lower government spending ratio, income tax rates have been cut substantially, and taxes on investment income are very low. Due to what Ms Harney calls "the incentive power of taxation", revenues have grown and "the choice between cutting taxes and improving social services" has proved to be a false one.
- Like New Zealand's, Ireland's annual inflation rate has been low – averaging 2 percent in the past five years.
- With the exception of agriculture, Ireland's economy is very open – its industries compete without protection in European Union markets. Its attitude to foreign investment is welcoming: "In New Zealand, you seem to have a fear of foreign industries. In Ireland we embrace them enthusiastically", Ms Harney says.
- Ireland has not undertaken the kind of labour market reforms that have been implemented in New Zealand and Britain. Its unemployment rate has only fallen

from 17 percent in 1986 to around 10 percent today. The government has plans for employment and welfare reforms.

In addition, Ireland has been deregulating previously sheltered sectors of its economy and reforming its public sector, and Ms Harney stated that it plans "a more ambitious programme of privatisation".

It is perfectly true that Irish governments have maintained numerous subsidies and tax concessions to companies to set up operations in Ireland, many of them funded from Brussels. Being a declared depressed zone, Ireland's (European Union) EU transfers peaked at close to 6 percent of GDP but they are now falling. But the subsidies have not been matched by a comparable contribution to employment or national income, and Ireland's share of Europe's inward direct investment has not been growing.

Following its earlier reforms, New Zealand dramatically improved its ranking in indexes of economic freedom, and has maintained fourth position in the 1999 Heritage Foundation/ Wall Street Journal index. Ireland has also improved rapidly to occupy seventh position in the same index.

Beyond an element of catch-up, Ireland's overall economic story is clearly one of less rather than more government intervention. The standout difference between Ireland and New Zealand in recent years is Ireland's much stronger fiscal discipline. Arguably existing interventions in agriculture and industry are preventing Ireland from achieving its full potential; at the very least it is quite implausible to maintain that they are major ingredients in its success, given the importance of many more fundamental factors.

In short, Ireland's success confirms the virtues of a liberal economic agenda. The main lesson for New Zealand is that instead of falling behind other countries in implementing this agenda as it has in recent years, it must restore the momentum and sustain it.

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