Choosing a First World or a Third World Future

New Zealand Business Roundtable
December 2001

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.

First published in 2001 by the New Zealand Business Roundtable,
PO Box 10–147, The Terrace, Wellington, New Zealand
http://www.nzbr.org.nz

ISBN 1–877148–76–8

Production by *Daphne Brasell Associates Ltd*, Wellington
Printed by *Astra Print Ltd*, Wellington

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List of Abbreviations

AA	Automobile Association
ACC	Accident Compensation Corporation
ANU	Australian National University
BNZ	Bank of New Zealand
CEO/s	Chief executive officer/s
CER	Closer Economic Relations
CRNEC	Centre for Research in Network Economics and Communications (University of Auckland)
CSR	Corporate Social Responsibility
DFC	Development Finance Corporation
ECHR	European Court of Human Rights
ECJ	European Court of Justice
GDP	Gross domestic product
GST	Goods and services tax
IMF	International Monetary Fund
ISCR	Institute for the Study of Competition and Regulation
ISPs	Internet Service Providers
MMP	Mixed Member Proportional electoral system
MNEs	Multinational enterprises
NECG	Networks Economic Consulting Group
NGOs	Non-governmental organisations
NHS	National Health Service (Britain)
NZIER	New Zealand Institute of Economic Research
NZS	New Zealand Superannuation

OE	Overseas experience
OECD	Organisation for Economic Cooperation and Development
PSTN	Public Switched Telephone Network
R&D	Research and development
RMA	Resource Management Act 1991
TEAC	Tertiary Education Advisory Committee
TIE	Targeted Individual Entitlement

FOREWORD

This collection of speeches, submissions and articles is the seventeenth 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), *Wake Up New Zealand* (1999) and *Can New Zealand Afford to Replay the Economic Past*?(2000).

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

It includes three papers by Bryce Wilkinson, consultant to the NZBR; articles by authors of a number of NZBR reports published in 2001: Phil Barry (*How Do We Compare? New Zealand's Public Policy Directions in an International Context*), David Henderson (*Misguided Virtue: False Notions of Corporate Social Responsibility*), Winton Bates (*How Much Government? The Effects of High Government Spending on Economic Performance*) and James Cox (*Middle Class Welfare*); and a speech by NZBR visitor Virginia Postrel.

A full list of NZBR publications is also included.

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ECONOMIC DIRECTIONS

ARTICLE BY RALPH NORRIS FOR THE
NEW ZEALAND HERALD

CHOOSING A FIRST WORLD OR A THIRD WORLD FUTURE

FEBRUARY 2001

CHOOSING A FIRST WORLD OR A THIRD WORLD FUTURE

The story of New Zealand's long-run slide down the international league tables of average per capita incomes is well known – from near the top 100 years ago to around thirtieth place today.

Less well known is the fact that New Zealand recovered ground during the 1990s. International Monetary Fund (IMF) data show that New Zealand's economic growth for the decade 1992–2001 averaged 3.1 percent a year, a vast improvement on the 1.2 percent annual growth rate for the decade 1982–91. New Zealand did much better in the 1990s than the European Union (2.2 percent) but less well than Australia (4.1 percent) and the United States (3.7 percent).

In turn, the average figures for New Zealand mask an outstanding performance in the early and middle part of the decade, when New Zealand achieved the best job creation record in the Organisation for Economic Development (OECD), and a weaker performance in more recent years as efforts to build on the earlier success fell away.

As former secretary to the Treasury, Graham Scott recently put it: "The notion that New Zealand has had 15 years of relentless 'free market' reform glosses over an untidy reality. We have had two periods of radical policy announcements to reform the role of the state – the mid-1980s and 1991–92. In between these two periods there have been consolidations, policy modifications, policy reversals, changes in leadership at various levels and a return to more familiar pragmatism driven by political resistance to some of the changes".

Average per capita incomes in Australia are now around 40 percent higher than in New Zealand, yet there is much concern in that country about Australia's economic under-performance and the challenges it faces with globalisation. The number one issue for many Australian businesses is the 'brain drain'; attempts to downplay this threat in New Zealand deny reality.

It is not as though New Zealanders do not want better living standards. The economy is not everything, but in a 1999 Massey University survey of attitudes and values about politics and government, support for economic growth came out far ahead of other goals, overall, and for virtually all political parties except the Greens.

A concern for growth must translate into a concern for the business environment. Businesses will not create wealth and jobs if policies and institutions are not conducive to growth. That is the lesson of the Soviet Union and the third world.

There is little mystery about the prerequisites for economic growth. Key elements are: relatively free and open markets, respect for property rights and contracts, sound money, modest spending, tax and regulatory burdens, high quality education and avoidance of welfare dependency.

Much harder is the task of achieving community consensus about sound policies. In the United States there is more of a consensus: in the recent presidential campaign, Al Gore declared "I don't ever want to see another era of big government", and no US politician could succeed on a platform of big government today.

Other countries have developed a consensus for smaller, better government. Ireland, which was a basket-case economy in the 1980s, is now just behind Hong Kong and Singapore in the rankings of economic freedom. Government spending in Ireland has almost halved as a share of the economy, from over 50 percent in the mid-1980s to a projected 26 percent next year (New Zealand's ratio is around 40 percent). There is a strong consensus in Ireland for its reforms: the push for privatisation, for example, originated with its Labour Party.

I do not believe the values of most New Zealanders – as opposed to some in politics, education and the media – are antagonistic to those needed for economic success. The Massey University study showed that, although there is still strong attachment to government intervention (despite overwhelming disillusionment with government), far more people see competition as good rather than harmful, support private ownership of business and favour personal responsibility and freedom of the individual. There is also a sound instinct that the priority equity goal should be the alleviation of poverty not the narrowing of income gaps as such.

Attitudes to business are less positive, and business must rise to the challenge of earning greater respect. Business performance also affects growth. Some New Zealand businesses have destroyed a lot of shareholder wealth, and New Zealand still has a long way to go to develop a deep reservoir of business skills and an entrepreneurial culture. By contrast, I believe that criticisms of unethical conduct in business, inadequate commercial laws and a lack of social responsibility are grossly exaggerated.

The constituency and the capacity for economic growth-oriented reform have been weakened in New Zealand by negative attitudes towards business, opposition from entrenched interests, failures in political leadership and the advent of the Mixed Member Proportion (MMP) electoral system.

Yet the case and the evidence for revitalisation are stronger than ever. Former senior OECD official David Henderson has recently written: "The critics of economic reform are wrong to argue that liberalisation has been taken to extremes over the past two decades, so that a healthy 'communitarian' reaction is now due … Liberalisation is still, on balance, going ahead in many if not most countries, including some of the largest. There are only a few countries where the current trend is in the opposite direction: examples are New Zealand, Venezuela and Zimbabwe".

The benefits of sound economic growth are widely distributed: recent World Bank research confirms that, internationally, growth has been good for the poor. Policies for redistribution can do much less to raise living standards, and, taken too far, they undermine the all-important incentives for people to work, invest and create wealth.

But growth is a long-haul business. It must be sustained by continuous improvement of policies and business practices, and supportive and stable public attitudes. New Zealand showed in the 1990s that an economic turnaround is possible. Equally, however, New Zealand could resume a long-run slide. The difference between a first world and a third world future will be determined by what the community understands and chooses.

ARTICLE BY ROGER KERR FOR THE
NATIONAL BUSINESS REVIEW

NEW ZEALAND IN 2011: SURFING OR STILL BEACHED?

SEPTEMBER 2001

NEW ZEALAND IN 2011: SURFING OR STILL BEACHED?

Just after the 1993 general election and the referendum that brought in MMP electoral system, I wrote an article entitled *The Beached Whale Economy?*.

The title was motivated by the stranding at the time of a large pod of whales on Farewell Spit. The stronger whales managed to push offshore, but others did not survive. Were they trying to tell us something, I wondered, about what happens to countries that lose their way?

Former prime minister, Jim Bolger's sacking of Ruth Richardson, and the electorate's decision to opt for an electoral system that was bound to lead to policy paralysis and compromise, signalled an end to serious efforts to improve the country's economic framework.

I suggested that in the immediate future New Zealand had the best prospects of economic growth for 20 years and that the forecasts of only slow falls in unemployment were far too pessimistic.

It turned out that the economy averaged 4 percent annual growth in the five years to 1997, New Zealand experienced the fastest employment growth in the OECD, and the unemployment rate fell from 11 percent in 1992 to 6 percent by 1996.

I also suggested that with policy paralysis New Zealand risked a return to fiscal irresponsibility, credit rating downgrades, slippage relative to other countries that were pressing on with market-oriented economic reform, and vulnerability to economic crises.

That would not produce "a blow-out that would land us in the ditch. Rather, the air will slowly go out of the tyres as investors move money and jobs to more attractive locations". Indeed it did; the economy was hit by the Asian downturn and has averaged only 2–3 percent growth over the past few years.

It is easy to predict that the outlook will be more of the same over the next decade unless policies change. A forthcoming New Zealand Business Roundtable paper describes Tasmania's experience to illustrate the risks that New Zealand faces. Tasmania's disadvantages of size and location have been compounded by bad policies over a long period. Being part of Australia has not saved it.

The study explains how Tasmania developed anti-business policies in the key areas of public expenditure, taxation and regulation and has suffered from Green politics, with resulting economic stagnation. A Tasmanian future for New Zealand "is one where many in the community will not simply be prepared to put up with persistently dismal economic and job prospects. Rather, increasing numbers will seek their fortunes elsewhere".

Already average incomes in Australia are 40 percent higher than those in New Zealand. The Australian Treasury believes Australia's sustainable growth rate is around 4 percent per annum, which compares with about 2.5 percent in New Zealand under present policies. On this basis, average Australian incomes will be around 60 percent higher than New Zealand's in 10 years' time. It is not difficult to imagine the 'giant sucking sound' such a differential would create as businesses and mobile people disappeared across the Tasman and to more dynamic economies further afield.

Despite being in denial about the brain drain and other trends, politicians are now talking about restoring New Zealand to the top half of the OECD rankings. In principle this is encouraging. Such a goal implies the need for annual growth rates of 5–6 percent and, to be credible, major policy adjustments. Overwhelmingly, national prosperity depends on the quality of public policies and institutions.

There is much less debate today than is often supposed about what constitutes sound policies. At the Knowledge Wave conference, the least market-oriented speaker, Robert Wade, dismissed European-style 'third way' policies as a useful option. Instead, he argued New Zealand would do better with Australian policies. As Graeme Hunt reported recently, I said the same thing in a speech some months ago. WestpacTrust chief executive Tom Gallagher has pointed out that "The Australian economic reforms have been slow, but certainly more persistent and far reaching than anything we have seen in New Zealand".

But I also remarked that Australian policies are not outstanding, and that New Zealand must have superior policies than more favoured countries if we are to outperform them. Australia has a much lower total government spending and taxation burden than New Zealand – some 33 percent of gross domestic product (GDP) compared with our 40 percent – and more restrictive welfare policies. No country has sustained 5–6 percent growth rates with a government spending ratio as high as 40 percent of GDP. To surpass Australia's performance, a basic requirement is to cut the size of government and not just match Australian tax rates but achieve lower ones. Do New Zealand political parties accept this logic?

If so, there is a chance of a broad community consensus for the kind of small government, free-market policies that we see in small economies like Hong Kong, Singapore and Ireland, and of achieving similar levels of prosperity in 10 years' time. Greater prosperity creates the potential for better health and education services, greater social cohesion, less crime and more resources devoted to the environment. If not, the conclusion of a recent Treasury paper that on present trends New Zealand's ranking among the OECD countries will continue to fall towards the bottom of the OECD rankings is the probable scenario.

WAIRARAPA AGRICULTURAL SEMINAR

A VISION FOR AGRICULTURE

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NEW ZEALAND BUSINESS ROUNDTABLE

MASTERTON
19 JULY 2001

A VISION FOR AGRICULTURE

The topic I discuss here is 'A vision for agriculture'. I have to confess that I am cautious about visions. Great visionaries of the twentieth century included Lenin, Mao, Pol Pot and Fidel Castro. The results of their visions were devastating. On a recent radio programme I heard a Russian saying that Russian politicians should stop having visions. The failure of every past vision had left the population feeling more disillusioned and hopeless than ever.

Of course I do not want to knock the idea of visions in a general way. Much depends on who is having the vision and how the vision is expressed.

It is fine for individuals to have visions – indeed I wish many New Zealanders had higher aspirations. It is also fine for corporate entities such as a company, a school, a government agency or a voluntary organisation to have visions. They can set goals and devise strategies for achieving them. Visionary leaders can motivate teams and inspire them to achieve great things.

Where we get into trouble with vision-talk is with other kinds of entities, in particular when we talk of national visions. A country is not a company. The citizens making up a country do not have a single vision – people are not clones. They have diverse and sometimes conflicting preferences, values and visions. A society is a civil association not a corporate association. Nor can an industrial sector like agriculture have a single corporate vision. The world would starve if countries adopted a Soviet vision for agriculture.

Treating a country as though it were a company (New Zealand Incorporated, so to speak) quickly leads to a grandiose view of the role of government and central planning visions. A perennial favourite is a target for economic growth. In New Zealand we have had so many visions of this type that we must be close to being visioned out.

In my working life this national sport began with the National Development Conference of the late 1960s. In response to concerns about New Zealand's faltering economic performance, it set a national growth target of 4 percent per annum (plus specific targets for sectors like agriculture). They were not achieved, and the 1976 report *New Zealand at the Turning Point* commented that:

> … those responsible did not heed the glaring discrepancies which emerged between targets and actual performance, and failed to modify policy accordingly.

Not deterred, however, the New Zealand Planning Council in 1978 set a five-year target of 3 percent annual growth, which again was not met. For a while during the 1980s the third Labour government concentrated on actions not growth targets, but play resumed in 1990 with the Trade Development Board wanting New Zealand to become '10 by 2010' – the tenth wealthiest country in the OECD area. A bit later, at about the time it gave up on economic reform, the Bolger government came out with a 3.5–5 percent annual growth target for the period to 2010. Winston Peters trumped that with a 6 percent target. In the 2001 budget the minister of finance set a target of 4 percent or more. The prime minister has spoken of New Zealand getting into the top half of the OECD by 2010. The ACT Party has adopted the '10 by 2010' goal. The leader of the opposition has talked about doubling New Zealand's growth rate. There cannot be many other options left on the menu.

The problem remains the same as that identified in the 1976 report. The Bolger–Birch government did not show the slightest concern about the discrepancies between its goals and its performance, despite endless attempts to point them out. The goal of getting back into the top half of the OECD by 2010 would require real per capita income to grow at an annual rate of somewhere between 4.6 and 7.4 percent, depending on the assumptions made. There are currently no signs that the government is contemplating the radical policy changes that could move the country towards such a goal. On present policies it is more likely that New Zealand's ranking among the OECD countries will continue to fall. Unrealistic goals that governments have no intention of pursuing are diversions and a recipe for disillusionment. We might as well dream of inventing a grass-eating pig that lays eggs.

In any event, a goal of achieving a particular growth rate is a central planner's vision, not a vision for a free and democratic society. We would no doubt get a lot more growth if the government legislated for a 60-hour working week, but is that what most New Zealanders want? Supporters of the Green Party might not want any growth at all. Should their preferences simply be overridden? A vision for a democratic society needs to be expressed in quite different terms – such as maximising opportunities for people to achieve their own goals, provided they do not interfere with the rights and freedoms of others.

Besides these outbreaks of 1970s 'growthmanship', several other visions and pseudo-economic ideas have featured in recent public debate.

For a start, there has been much talk about a 'new economy'. One implication is that 'old economy' industries like agriculture are losers; our river flats should be converted into Silicon Valleys. Proponents of the 'new economy' have looked foolish as the hi-tech boom turned into a hi-tech bust. The best performing sector on the Australian stock exchange in the past year has been building materials – an old economy sector if ever there was one. The collapse of many of the dotcom companies simply showed that the old laws of economics still apply.

Talk of a 'knowledge economy' is not much more helpful. Knowledge has mattered for economic progress ever since hunters and gatherers left their caves. The shift from manpower to brainpower has been going on at least since the industrial revolution. Innovations in information technology are just one of many waves of innovation since that time.

This is obvious in agriculture. Turning ultraviolet light and soil nutrients into casein, a lamb rack or an award winning wine that competes on world markets is enormously intensive in knowledge. In fact, it has only been through constantly expanding the base of knowledge in farming that we have been able to maintain a vibrant agricultural sector. If all farms were to revert tomorrow to using the technologies and knowledge that were around in, say, 1950, they would be out of business by the end of the year.

Moreover, knowledge and wealth creation should not be equated with higher education, important as education is. The celebrated speech by Larry Ellison, chief executive of Oracle, that was circulated widely on the internet last year was apparently apocryphal but it contained an element of truth. It had him telling a class of graduates at Yale University that he, the second richest man on the planet, was a college dropout and they were not. So were Bill Gates and Paul Allen, the first and third richest men respectively. Among various other heresies the audience was told:

> Leave. Pack your things and your ideas and don't come back. Drop out. Start up … A cap and gown will keep you down just as surely as these security guards dragging me off this stage are keeping me down.

The point is that wealth creation is primarily due to entrepreneurs, not people in white coats; and the most important stimulus to entrepreneurship is open markets with relatively light taxation and regulation. We need to put as few obstacles as possible in the way of entrepreneurs and ensure they get rewarded when they succeed.

There has also been a lot of loose and often self-interested talk about New Zealand's dependence on primary industries and the need to move away from 'commodity production' and into 'value added' activities and 'further processing'.

All this is more pseudo-economics. There is nothing wrong with producing commodities if that is what we do best. Commodities have to be produced and some countries will have a comparative advantage in producing them. Commodities comprise about 55 percent of Australia's goods and services exports, which rose by 23 percent last year. Far from being impoverished hewers of wood and drawers of water, Australians enjoy per capita incomes that are now around 40 percent higher than ours. Australia was one of the best-performing countries in the OECD in the past decade.

In any case, what is a commodity? McDonald's hamburgers and Starbucks coffee are surely commodities, yet they have made great wealth for investors. So too are international toll calls, standard banking services and air travel, in the sense that competition for these largely undifferentiated products is mainly on price. Some people seem to think that commodities are the wrong business to be in because they fall in price – that agricultural terms of trade are poor. In fact New Zealand's agricultural terms of trade have risen slightly in the past 10 years whereas the prices of many so-called 'new economy' products have fallen like a stone – Microsoft's Windows prices by 50 percent, telecommunications toll charges by much more.

'Value added' talk is even more confused. Value added is just production or GDP. At the level of the economy or the firm it is simply the value of production less the cost of inputs. Of course we want more value added in the sense that we want increasing production and higher national income by using scarce economic resources better. But there is no more to it than that. There may be as much added value in a seedling growing into a tree as in the most sophisticated microprocessor.

By value added some people mean further processing of so-called raw materials (like a log). But this may or may not make sense for firms or the economy. Further processing involves costs that may exceed the additional revenues. The important issue for wealth creation is the return on investment. This may be higher at the margin for logs than for processed wood products.

Furthermore, just because an activity adds value does not mean we should be pursuing it. We might well be able to add value using thermal steam to heat glasshouses to grow bananas in – but the capital and labour involved would very likely generate better returns in some other activity.

All this is elementary economics, but elementary economics does not seem to feature in some of our current debates. Whenever New Zealanders get anxious about the country's economic performance, new and old nostrums get hawked around. The list is familiar: promote hi-tech industries, subsidise research and development (R&D), cut the company tax rate, join Australia, double the population, adopt the US dollar. Some of them may have merit; others are as foolish as the late 1960s idea of closing down the dairy industry. But they do not add up to a coherent economic strategy. Talk of 'kick starting' the economy or finding a 'circuit breaker' has no basis in any serious analysis of economic growth.

At a precursor to the Knowledge Wave conference, the former Canadian prime minister Brian Mulroney made some basic points about economic policy. He observed that there was little new or revolutionary about the lessons of economic success. There was no single panacea – a country had to get a lot of things right. Key requirements included low inflation, free trade, openness to foreign investment, deregulation, privatisation, low taxation and good education. Relatively unrestricted labour markets generating high levels of employment, the avoidance of welfare dependency, and good institutions – such as secure property rights and a sound legal system – could be added to this list. Mulroney went on to say that such a programme had to be durable and applied consistently, not overturned with every change of government. I am not sure that his audience got the message. But as the *National Business Review* said in a recent editorial:

> Unless the Knowledge Wave conference addresses the key drivers of wealth creation – greater direct foreign investment, low tax, smaller government and a climate that fosters innovation – it will be an expensive failure.[1]

The general answer to questions about the future of agriculture in New Zealand is also fairly elementary. Broadly speaking, agriculture will do well in an economy that is performing well and it will do badly in an economy that is performing badly. Over the last 15 years agriculture (including off-farm processing) has more than maintained its share of GDP – it has gone from 14.2 percent of GDP in 1986/87 to 16.6 percent in 1999/00. So much for farming being a sunset industry. The key to this performance has been productivity growth – an annual increase of 3.9 percent in total factor productivity compared with 1.1 percent for the whole economy. The Employment Contracts Act 1991 was a pivotal factor in this productivity improvement.

Right now farming overall is on a roll – farmers are enjoying their best year for 20 years according to some accounts. Yet average sheep and beef farm profit this year is estimated to be around $90,000 and dairy farm profit around $120,000. These are modest sums for what are large enterprises. Even at current levels the returns hardly stand out relative to long-term returns from investment on the stock exchange.

Around 1993–94 farm incomes also rose when the economy's international competitiveness lifted and economic growth took off after the years of economic reform. Farmers became far too complacent about the future. They generally turned a blind eye to the spending sprees and policy drift of the Bolger–Birch governments. A few years later the sector and the economy were back in the doldrums. The current recovery in farming has happened on the back of favourable international conditions and a weak dollar, itself largely a result of several years of economic mismanagement. These conditions will not persist: the economy as a whole is not in good shape; export volumes are not growing strongly; investment is relatively weak; and the medium-

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1 *National Business Review*, 6 July 2001.

term prospects are for growth of only 2–3 percent a year. Agriculture will not be doing well until its performance this year is routine (barring adverse weather conditions), not a one in 20 year event.

In particular, farmers should be mindful that currency depreciations only improve profitability temporarily. Currently the economy's real exchange rate (that is, the nominal exchange rate adjusted for differences in relative inflation rates or unit labour costs) is currently well below its long-term average. It will drift back to the average or above at some point in time. The only issue is whether the path upwards is part of a benign scenario based on a higher nominal exchange rate underpinned by a good relative inflation performance and cost reductions in the non-traded sector, or whether competitiveness is lost due to higher inflation and wage increases not backed by productivity improvements. In the interests of achieving the former scenario, farmers should be among those calling loudest for lower government spending and taxation and for microeconomic policy reforms to promote cost reductions and innovation.

In respect of innovation, the main barrier to change within the farming sector has undoubtedly been the archaic producer board structures. These are now in their death throes, but it has been an agonising process. My main reflections on a 10-year debate would be the slowness of farmers to get to grips with the basic economic arguments; the debilitating politics within the sector; the time that has been lost before change has occurred – and then sometimes only in the face of crises (as in the wool and apple industries); and the low quality of some final outcomes, in particular in the dairy industry. This industry will still be highly regulated rather than put on the same basis as most other industries. More change will be needed in the period ahead, including within its cooperative structure where the bundling of on-farm and off-farm returns remains a huge distortion.

In my view it is these issues of broad national economic policy, including policies specific to agriculture, that farmers should keep their eyes firmly focused on through their representative and commercial organisations. The vision they should embrace is one of an open, competitive, dynamic economic environment in which entrepreneurs in all sectors can make the most of the opportunities it offers.

By contrast, we should recognise that in the so-called knowledge age we are probably more ignorant than ever about the concrete form those opportunities might take, even in the next 10 years. Ten years ago the internet barely existed. Who could have foreseen its impact on households, businesses and our general way of life today? In the next 10 years it is easy to speculate that the impact of developments in biotechnology will be just as profound. But none of us has any overall idea about their scale or form. It would be a conceit to pretend otherwise.

Nor should that worry us from a national policy perspective. If we allow sensible applications of biotechnology rather than stifle them with a misplaced 'precautionary principle' approach, entrepreneurs will soon discover them – New Zealanders are not slow to adopt new technology. A strong R&D industry drawing on international advances in genetic engineering – while monitoring any risks – would create an environment in which entrepreneurial farmers can choose the type of technology that best fits their circumstances and markets. I expect other entrepreneurs will find new opportunities for growing and selling organic products, to the extent that consumers demand them. Both genetic modification and organic approaches to farming should co-exist, and farmers should be free to put their money on the line and test the market opportunities. It is plausible to argue that New Zealand's future very likely lies in the same place as our past: as a wealthy exporter of primary and resource-based products. But none of us really knows what the agricultural sector will look like in 10 years' time, or how it will fare in the competition for resources with profitable opportunities elsewhere in the economy.

What we do know is that governments will maximise the opportunities for New Zealanders if they refrain from making these kind of judgments about industry winners and losers, and concentrate on lowering the barriers to entrepreneurship and wealth creation. The agricultural sector has every reason to cast a jaundiced eye on government-sponsored visions. A vision to industrialise New Zealand and reduce our dependency on agriculture brought us high import barriers, a cost-plus economy, a farm sector that had to be propped up by subsidies, the madness of Think Big, and ultimately the need for a wrenching, economic restructuring. The record of disasters associated with governments that have had visions of that kind is long and well documented.

I suggest that it would be folly for New Zealand to go down the road of 'hands on' state intervention again. In today's complex society governments should strive for simple, general rules to guide business life and allow entrepreneurs to realise their own visions. They should not attempt to impose a corporate vision, growth targets or national plans on the economy or any sector of it. With the collapse of the centrally planned economies, we should have worked out by now that, as an Australian economist once put it, governments should emphasise:

> … dynamic efficiency, flexibility and the capacity to sail … on the shifting socio-economic winds rather than trudging relentlessly on with fixed structures to inevitable defeat in the snows of Moscow.[2]

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2 Richard Blandy in Israel Kirzner (1984), *The Role of the Entrepreneur in the Economic System*, Centre for Independent Studies, Sydney.

**NEW ZEALAND INSTITUTE OF
INTERNATIONAL AFFAIRS CONFERENCE
'AUSTRALIA AND NEW ZEALAND: WHERE ARE WE NOW?'**

ECONOMIC QUESTIONS: CHOICES FOR NEW ZEALAND

**MURRAY HORN
MEMBER
NEW ZEALAND BUSINESS ROUNDTABLE**

**WELLINGTON
4 JULY 2001**

ECONOMIC QUESTIONS: CHOICES FOR NEW ZEALAND

When Bryce Harland asked me to speak, he said he wanted someone to take a fresh look at trans-Tasman issues. Accordingly, what I seek to do in this presentation is to rethink choices for New Zealand in a structured way, developing a process of logic rather than summarising existing arguments. I hope to come to some conclusions about how the economic relationship between Australia and New Zealand might move forward and to add some new ideas to the discussion.

Bryce Harland posed me the question 'Is New Zealand viable?' as a distinctive independent jurisdiction. In one sense, this is an easy question. If we were to cut ourselves off from the world in Soviet style, New Zealand would still be viable in the sense of being able to survive. We would be poor, we would be greatly stressed, but our survival would not be at issue. We would still be making some choices for ourselves. But that is hardly what the question means. So what is really meant by 'viable'? In my view the interesting question is 'What laws, what regulations, what standards, what institutions should we decide to have in common with another jurisdiction?'.

I ask that question recognising its public choice value. First, when we decide to have a law in common or an institution in common with another jurisdiction, the evolution of that law or institution is likely to be less responsive to local political processes. Secondly, any jurisdiction we would be likely to get close to (and in this case we are focusing on Australia, though we should keep the United States in mind) is more likely to be in the nature of a takeover than a merger. Someone once asked me what the merged entity would be called if New Zealand merged with Australia. The answer would be 'Australia'. So the question about viability is really about whether we want to adopt the laws, regulations, standards or institutions of another jurisdiction. Finally, we have to realise that our capacity to choose takes us only so far. At some point we need a willing partner. We have, as an example – the most dramatic one to my mind – the links that exist with the Privy Council. The United Kingdom authorities have agreed that we can retain access to the Privy Council. This has much to commend it and we have chosen – so far – to keep that institution.

In developing an answer to the viability question I have made two important assumptions. The first is that just because we throw in our lot with another jurisdiction – let us say completely – does not mean that we get the general outcomes of the other jurisdiction. If we were to throw in our lot with Australia, we might end up like Tasmania. We would not necessarily end up like Sydney. There are enough regional variations to mean that making a decision to combine is, in itself, not enough to dictate the outcome.

My second assumption is that talent and capital are highly mobile. If it is attractive to do so, talent and capital will move to the more attractive location. More than that, New Zealand is small and distant. To overcome the problems of size and distance our policies have to be much better than average. That is a consideration that warns against simply adopting the policies of another jurisdiction.

With such assumptions in mind I reach an obvious initial proposition, which is: retain the institutional choices that we have and choose policies and institutions because they are good, not just because they are Australian. How many people on either side of the Tasman could honestly say, for example, that Australia's goods and services tax (GST) is better than ours? Why would we give up a good GST for a poorly implemented one?

This initial proposition has one very important implication: if we are going to hold on to our independence, we had better use it to make good choices.

This is relevant to the discussion because much of our policy governing the way we interact with the world imposes very useful disciplines on our domestic choices. Being open to capital markets, for example, means our monetary and fiscal policy decisions are quickly reflected in exchange and interest rates. Poor decisions produce painful messages. Openness to capital and talent means that money and people take off if New Zealand governments do something silly in policy terms. Being open and independent is, therefore, better than being closed and independent because we are more likely to use our independence to make better choices.

That is my initial proposition. Let us test it a bit further. If one really believes New Zealand should maintain independence, then why not independence for the South Island? That question made me think – is there not something wrong here? Independence is obviously not the whole story.

What is there about the South Island that makes independence for that geographical area intuitively unattractive? In my view there are four things. The first is an obvious one, and that is scale. Were the South Island to declare independence from New Zealand, it would incur huge overheads, especially government and public goods overheads. Imagine the South Island with its own defence force, its own foreign affairs department and its own parliament. These are sizeable items. Not only that, there are other scale problems relating to talent. It is hard to attract and keep talent when the variety of opportunities is limited. There are scale problems too with the quality of institutions. What is the chance of the South Island being able to maintain a world class tertiary medical establishment or higher educational establishment? It is much more likely to be able to do that in the context of a New Zealand jurisdiction.

Further, there are transaction costs, which we know are important even if we do not know exactly how much they matter. The only point of being an independent South Island would be to have rules, laws, regulations, standards and institutions that are different from the rest of New Zealand. But anything that is different imposes costs. Anyone who wants to deal with the South Island would have to learn how and what things were different in the South Island. Therefore dealing with the South Island would become more expensive. That is the argument about core transaction costs.

Where would the benefits for the South Island come from? Would an independent South Island be sufficiently different from the rest of New Zealand that being independent would really make much of a difference? Cultural and political interests and other sources of heterogeneity have to be different enough to be likely to lead to systematically better choices from the viewpoint of the relevant population. Why would the South Island want to be independent just to have institutions that are distinct? Are South Islanders' political interests different enough and are their cultural tendencies different enough to yield better choices for them than they would get in the context of New Zealand as a whole?

Finally, if South Islanders did 'go it alone', would that preclude their ability, on their own, to amalgamate with some other jurisdiction, like Australia or the United States? If it did, that would not be attractive – it would remove a valuable option. Perhaps that is hard to imagine, but it is certainly a factor to weigh up.

All these are problems with my initial proposition, so it needs modification. In retaining our ability to make the best policy and institutional choices for ourselves, we should look for disciplines that lead us to make good choices. We should also seek to reduce the problems of scale and transaction costs associated with being independent, and we should not prejudice what I would call the American option. In other words, we should make it easy for us to 'dock' with other jurisdictions in the future. So, that is the new, refined, proposition.

When we take this new proposition, what does it say about the economic relationship between Australia and New Zealand?

Much of what we have been discussing today is consistent with that proposition. The whole Closer Economic Relations (CER) project, free trade in goods and services and free movement of capital and labour, makes sense in terms of it, and if we believe in this modified proposition we should go much further.

There are still contentious issues around the CER agenda and we need to address as many of these as we can. Mutual recognition, for example, has the real possibility of allowing the better rules, standards, regulations and institutions in each jurisdiction to prevail gradually over the less desirable – a reversal of the old Gresham's Law in coinage that bad money (that is, counterfeit money) drives out good.

We should also make it easier to 'dock' with the United States eventually, as well as Australia, by making New Zealand more attractive as an economic partner and by removing potential blockages to integration. That creates a useful safety value and also helps discipline local decision making. At the extreme, if New Zealand policies ever became too dominated by concentrated minority interests, 'easy docking' would make it easier for the majority diffuse interest to rouse itself enough to vote for some form of union and, therefore, water down the influence of concentrated local interests. Current economic and constitutional arrangements probably make it far easier for us to dock with Australia than with the United States.

The modified proposition also identifies some new agenda items that might be worth further consideration, especially in relation to scale and transaction costs. If we really are worried about these 'costs of independence' then we can reduce them without having to move all the way to political amalgamation.

Take defence as an example. I had the good fortune to listen to a former United Kingdom chief of defence staff earlier this year. He made the claim, effectively I thought, that Europe and Britain acting alone, that is without the United States, could really only sustain two things: a peacekeeping role and ready reaction forces. That sounds remarkably like what our Defence people used to say. If European and United Kingdom forces are able to do only that, New Zealand can certainly do no more. So if the prospects of an independent role are that limited, maybe we should move to a single defence force with Australia. That is one way of minimising the cost of being independent without throwing in the towel on everything else. It would not, for example, require us to accept the Australian GST!

There are other possibilities too, although not all will be congenial to everyone. In fact some might be even more controversial than a single defence force. While the South Island, for example, might find it difficult to have a truly world-class university or a truly sophisticated hospital system, there is more than one response. It could, for example, subsidise students and patients – rather than universities and hospitals – and let them be educated and treated in the North Island. Adopting this approach between

Australia and New Zealand would make it easier to get scale economies in health and education without having to go to full-blown political amalgamation. Students could be subsidised to attend the Australian National University (ANU) just as they are subsidised to attend the University of Otago. It would give us a chance to get better quality education and health institutions across the two markets. This would reduce the scale costs of standing alone and staying independent, but, again, would not mean that we would have to rush off and adopt an inefficient Australian tax.

Finally, in this area of reducing independence costs, we could do many things that would attract talent to our jurisdiction. Talent was one of the problems that we found with the South Island model, and it is a problem for New Zealand too. Policy could be more effective in attracting and retaining talent.

So there are some new ideas here, as well as old. The refined proposition points towards possible future policy initiatives as well as endorsing existing policy trends.

Lastly, the refined proposition says 'do not prejudice the United States outcome'. If we are going to get closer to Australia, share a defence force, make the flow of goods and services still more open, allow students to go to Australia for supported study and the like, we still would not want to prejudice other options. This is like the old trade diversion-trade promotion distinction. Reducing barriers to trade is generally desirable, but reducing barriers to one country more than others might divert trade to something other than the least-cost option. That is not desirable. Similarly, in the more general context, getting too close to one partner may not be wise if it takes us further away from a potentially more desirable partner.

I think we have to approach the United States on a bilateral basis as well as on a joint basis with Australia, if we can. Secondly, I would want to make New Zealand attractive as a partner of the United States at the same time that we were making ourselves attractive as a partner of Australia. I know that sounds promiscuous but I think it is probably the best thing for us to do. So it would be useful, for example, to build on the current interest in bilateral New Zealand–United States free trade and to have closer relationships with countries that are, or could soon be, in a free trade area with the United States so that they did not object to our eventually joining the wider arrangement.

That is where the new proposition takes us. We should maintain our freedom of choice and increase the disciplines on making better choices. We should look at reducing the scale and transaction costs of maintaining independence, while making docking with both Australia and the United States easier. These are the sort of things we should bear in mind in developing our economic relationship with Australia. What we should not do is jump to full integration right away.

My final reflection on this whole outward-looking foreign enterprise is that the main game is not about extracting trade concessions but about making ourselves better decision makers. The benefits of CER were not just that New Zealand firms traded more with Australia, though that was indeed a gain, but that it helped change the whole domestic focus of opinion towards openness in our economy. It changed the local constituency for openness – more people were interested in openness than were opposed to it, and that encouraged us to be more open to the rest of the world. The benefits of that transformation in our political culture are enormous.

OTAGO FOREIGN POLICY SCHOOL

THE NEW ZEALAND–AUSTRALIA RELATIONSHIP: A BUSINESS PERSPECTIVE

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DUNEDIN
30 JUNE 2001

THE NEW ZEALAND–AUSTRALIA RELATIONSHIP: A BUSINESS PERSPECTIVE

Introduction

This paper looks at the relationship between New Zealand and Australia from a business perspective. Given the dominant impact that government policy has on business and economic outcomes, it begins with a survey of the way the relationship between the New Zealand and Australian governments has evolved over the last two decades. The paper then explores the growing interconnections between New Zealand and Australian businesses. Finally, it considers what deeper relationships, at the political level, may and may not have to offer New Zealand.

Government relationships

It hardly needs to be said that public policies in Australia and New Zealand have moved a long way towards greater openness since the Closer Economic Relations (CER) agreement came into force in 1983. At that time policies were insular and highly interventionist in both countries. Both were becoming increasingly embarrassed by international comparisons of their economic performance, having once been (like Britain) among the wealthiest countries in the world. They were by no means equal under-performers: Australia had merely become a slow learner in OECD terms, while New Zealand was around the bottom of the class.

To the extent that Australians thought about New Zealand, it was seen as a millstone around Australia's neck. The country was becoming less important to Australia as a trading partner. Australian politicians and government officials had become frustrated with their New Zealand counterparts' petty-minded and bureaucratic approach to trade liberalisation under the New Zealand–Australia Free Trade Agreement, and with the seemingly incurable protectionist attitudes of New Zealand manufacturers. They effectively confronted the New Zealand government with a choice: either accept a comprehensive free trade agreement, or Australia would lose interest in efforts to free up bilateral trade. Some on the New Zealand side saw that stance as an opportunity to be grasped.

Looking back at the way the relationship between the two governments has developed since then, it seems that in many ways things have come full circle.

The Muldoon government in New Zealand prevaricated over CER but eventually bit the bullet. New Zealand firms adjusted and became more competitive, and the extended timetable for the removal of import licensing and tariffs soon became academic. With the Labour government's economic policy reforms from the mid-1980s, New Zealand started to re-emerge as a credible economic partner and Australian politicians and business people began to look at New Zealand in a new light. The New Zealand government followed Australia in freeing up financial markets, floating the exchange rate and implementing general tariff reductions. In some areas, such as privatisation, it implemented market-oriented economic reforms ahead of Australia. The country that Australians had virtually written off was being noticed internationally for the quality of its economic reform programme.

By the early 1990s, it was the New Zealand government that was wanting to force the pace of economic integration. Many Australian politicians crossed the Tasman to investigate New Zealand's economic reforms. A series of Australian firms relocated to

New Zealand or set up operations here. The Employment Contracts Act of 1991 – which contrasted with Australia's inefficient and cumbersome labour market regime – was one major drawcard. New Zealand reformers were to be found working in Australia. Indeed key features of New Zealand's reforms were copied in many parts of the Australian public sector, particularly Victoria. The former rust-belt state was transformed with a programme of fiscal reform, privatisation and major changes to the way many government entities were run. There was a loss of momentum in the later Kennett years, but it is interesting that the Bracks Labor government that followed shows few signs of fundamentally reversing the earlier changes.

New Zealand's economic performance lifted substantially from 1992 with strong rates of economic growth, rapidly falling unemployment, low inflation, a comfortable external position, a turnaround in net migration and a credit rating upgrade. However, the reform efforts of New Zealand governments were stop-start in nature and the programme progressively lost coherence and momentum. As former secretary to the Treasury Graham Scott recently put it:

> The notion that New Zealand has had 15 years of relentless 'free market' reform glosses over an untidy reality. We have had two periods of radical policy announcements to reform the role of the state – the mid-1980s and 1991–92. In between these two periods there have been consolidations, policy modifications, policy reversal, changes in leadership at various levels and a return to more familiar pragmatism driven by political resistance to some of the changes.[1]

By 1997 the growth momentum was falling away, imbalances were showing up and the economy was in a weak position to cope with the Asian downturn.

As a consequence, the new-found respect for New Zealand in Australia faded. The loss of interest has been compounded since the change of government in 1999, because New Zealand has been perceived as becoming more insular in its economic, defence and welfare policies. Economic policy changes that have attracted attention in Australia include New Zealand's halt to the removal of tariffs, despite the overwhelming evidence of the benefits of free trade;[2] the changes to employment law, which have made New Zealand's labour regime less attractive overall than Australia's according to experienced practitioners; and the increase in the top income tax rate. Although Australia has a higher top statutory tax rate than New Zealand – and this is a serious weakness in its tax system – there are many tax concessions that better-off individuals can take advantage of, just as they could in New Zealand prior to 1984.

Since the mid-1990s Australian governments have done a better job overall than New Zealand's in advancing economic reform. Spending by governments at all levels in Australia has been reduced from 35 percent of gross domestic product (GDP) in 1994 to 31 percent in 2000, according to the OECD. In contrast, total government spending in New Zealand is now much higher at around 40 percent of GDP (see the accompanying table), around the same level as in 1994. Australia is a much more lightly taxed

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1 Graham Scott, keynote address, Public Service Senior Management Conference, 1999.

2 For example, a paper by Jeffrey Frankel and David Romer published in the *American Economic Review* in 1999 (Vol 89, No 3) estimates that every 1 percentage point increase in the ratio of trade to GDP raises income per person by between .5 and 2 percent. Similarly, the OECD (1988) estimates that nations relatively open to trade grow about twice as fast as those that are relatively closed.

country than New Zealand, since government spending is the best measure of the overall tax burden.

Australia has made good progress in the last 10 years in dismantling most of its statutory marketing authorities whereas producer board reform in New Zealand has been slow, tentative and lacking in quality – particularly in respect of the dairy industry. Australia is in the lead in the privatisation and commercial operation of electricity, roading and water – industries that are still largely under political control in New Zealand. Australia's education system is ranked well above New Zealand's for meeting the needs of a competitive economy,[3] and its welfare system is less expensive and less conducive to dependency than New Zealand's,[4] although much needs to be done in both areas in both countries.

Australia–New Zealand comparisons – key indicators

	Australia	**New Zealand**	**Difference**	
	$	$	$	%[1]
GDP per capita at current prices US dollars in 1999:				
Purchasing power basis	25,721	18,532	7,189	38.8
Current exchange rates basis. 1999	21,492	14,376	7,116	49.5
	%	%	**Percentage points**	
General government spending as a percentage of nominal GDP 2000	32.7	40.2	–7.5	

1 The difference in GDP is expressed as a percentage of New Zealand's GDP.

Source: National Accounts of OECD countries, main aggregates www.oecd.org/std/gdpperca.htm, July 2001. General government total outlays as a percentage of nominal GDP, *OECD Economic Outlook* 69, Paris, June 2001.

Given the present public policy malaise in New Zealand, it would be helpful if Australia stood out as a shining light. In some ways the Howard government was showing the way again in its early years. Substantial progress was made, especially with fiscal policy, even though there were messy compromises in areas such as telecommunications and the introduction of a goods and services tax. Over the last year, however, the momentum of reform has been lost. The Howard government's recent budget was aptly described in the *Sydney Morning Herald* as a "big spending election Budget" with A$3 billion in giveaways for the elderly alone. Industry policy is becoming interventionist again, with subsidies to loss-making companies, bailouts to insurance company policyholders and vote-catching regional policies such as the absurd 'Darwin to nowhere' railway that will service about one train a day.

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3 In the *World Competitiveness Yearbook 2000*, New Zealand ranked in fifteenth place on the criterion 'Availability and qualifications of human resources' while Australia was in sixth position (International Institute for Management Development, Lausanne, Switzerland).

4 See Cox, James, *Towards Personal Independence and Prosperity: Income Support for Persons of Working Age*, New Zealand Business Roundtable, 1998.

Competition policy is in disarray, and opposition parties with policies that would set the clock back in areas like industrial relations and privatisation are polling strongly.

New Zealand has been living off the benefits of its past reform efforts in recent years. The OECD assessed in 1999 that, as a result of its economic reforms, New Zealand's potential economic growth rate had risen to around 3 percent per annum, about double its sustainable pre-reform growth rate.[5] The idea that the reform programme failed to deliver significant benefits is simply untenable. But, as a result of further policy slippage, the government's own projections suggest the economy is now set to grow by only 2–3 percent a year in the medium term, and the risks of a worse performance are significant. Yet to reach the government's goal of restoring New Zealand's income levels to the top half of the OECD countries, New Zealand would have to achieve annual growth in per capita income of around 7 percent per annum for the next decade. That level of performance is simply not attainable on current policy settings. It is irresponsible even to be floating such a goal without acknowledging and signalling the sweeping policy changes that would be needed to achieve it.

Australia has been doing better than New Zealand in recent years largely because Australian governments have continued to improve their policy framework while New Zealand governments have allowed theirs to deteriorate. This is contrary to the situation only five or so years ago. Average per capita incomes in Australia are now between 39 and 50 percent higher than in New Zealand (as the table shows). The performance gap between the two countries seems likely to widen further in Australia's favour, even though its growth rates over the next few years are expected to be below those achieved in the 1990s.

The challenges of globalisation

There is growing concern in Australia about the challenges of globalisation. Writing recently in the *Australian Financial Review*, the respected business commentator Alan Kohler said:

> Australia's place is increasingly peripheral: no replacement has been found for its leadership in basic commodities; very few Australian companies have successfully built global businesses … [After News Corporation, Rio Tinto and National Australia Bank, the list of Australian corporations either moving abroad or thinking about it] is beginning to look like a list of the ASX Top 20: AMP, Amcor, AXA Asia, BHP, Brambles, Cochlear, CSL, CSR, Foster's, James Hardie, Lend Lease … Globalisation is without doubt the number one issue for Australian businesses as the new century begins and the difficulty of running a global business from Australia is the number one problem associated with it … The rest of the world is just too far away and our own consumer and capital markets are too small.

These challenges are magnified for smaller, peripheral and poorly run economies, such as South Australia and Tasmania, and they loom large for New Zealand. There is no doubt that governments can implement policies that reverse a drain of investment and people. Ireland proved that after its economic reforms of the late 1980s, as did New Zealand in the early 1990s. But equally, the problem can become endemic: Tasmania has been losing people for many years, and official projections suggest its population

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5 *OECD Economic Surveys: New Zealand*, OECD, Paris, 1999.

could halve by 2050. Of course many supporters of Green parties would regard this as a good thing, but their vision of Tasmania or New Zealand being poor and depopulated is hardly shared by the bulk of the population.

The fact is that governments are competing with each other in terms of the quality of their institutions (such as their electoral systems and their laws) and the policies that are put in place. Governments cannot ignore the fact that capital and skilled people are mobile and that both will tend to go to countries with more stable and secure property rights, lower tax rates and with business environments that are conducive to entrepreneurship and wealth creation. Commenting recently on his company's plans, the managing director of CSR said that "Australia's restrictive competition law, tax system and unwillingness to embrace globalisation could prompt CSR to move offshore after 146 years of locally based operation".[6]

Even with the best institutions and policies in the world, New Zealand faces the reality that it will make sense for some companies to move to other countries as they go though the product and business lifecycle. Both New Zealand and Australia have been called 'branch office' economies. But what does that term really mean? In a world of overlapping global networks, every country becomes a 'branch' for some activities. With open economies, head offices and production will be globally distributed. Do people in North Carolina worry that most of the products they buy are made by firms with headquarters in Atlanta or Chicago? Should Southlanders worry that they are customers of firms based in Christchurch or Auckland? Should I worry that I deal with the local branch of an accounting firm whose head office is in New York? Even if firms shift their head offices their production and distribution facilities are not necessarily affected. Moreover, their New Zealand and Australian shareholders benefit from successful international expansion. Many New Zealanders and Australians also benefit from improvements in their career prospects when companies go global. The real focus of any concern should be with poorly conceived tax, regulatory or other policies that bias decisions about where firms operate and adversely affect production and employment and domestic incomes.

Despite the vagaries in the pace and even direction of public policies in the two countries, many businesses are becoming increasingly integrated on a trans-Tasman basis. Air New Zealand, Lion Nathan, Fisher and Paykel, Carter Holt Harvey, The Warehouse, BHP-Billiton, CSR, James Hardie, most of the major Australian banks and insurance companies and several Australian retailers all have a major presence on both sides of the Tasman. The New Zealand and Australian dairy industries are moving closer together. Telecom NZ now derives around one-third of its revenues from Australia. It has set up its mobile and internet businesses on the two sides of the Tasman as single trans-Tasman business units, largely to serve its trans-Tasman business customers more effectively. Many New Zealand and Australian firms are also integrated on a much wider global basis.

I expect the business relationship between New Zealand and Australia to continue to expand and deepen over the coming years. This is part of the process of overcoming New Zealand's disadvantages of size and location. To offset these factors New Zealand also has to strive to be superior in the skills and effort of its workforce, the quality of its business management and, above all, in its institutions and public policies. These decisively influence whether countries prosper or languish. It takes

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6 'Now CSR is considering a move overseas', *Sydney Morning Herald*, 23 June 2001.

years, if not decades, to build confidence in institutions and policies, and that confidence can be easily undermined. New Zealanders will pay a price for many years for the erratic stances of successive governments on immigration and employment law, to cite just two examples.

The trans-Tasman government relationship

At the government level there is a lot of room for improvement in the relationship between Australia and New Zealand. There have recently been serious signs of deterioration. Likely reasons include the different ideological orientation of the incumbent governments and the general loss of interest among key Australian policymakers and business leaders in a slow-coach New Zealand. In many respects Australian attitudes of the 1970s have returned. Manifestations of the deterioration are numerous.

- In the labour market, the recent trans-Tasman Social Security Agreement marks an important change in the Anzac relationship. New Zealanders have now lost the right to Australian residency that they have enjoyed since 1948. They no longer automatically have the right to receive benefits like Australian citizens. These changes were effectively dictated by Australia and had a certain logic from an Australian perspective. Nevertheless, they represent a loss of opportunities to New Zealanders who will now be treated more like citizens of other countries. In Europe the trend is in the opposite direction as the single market is being complemented by greater opportunities for travel and work.

- The Australian government did not take kindly to the New Zealand government's decision to allow an amnesty for overstayers and lower the bar on immigration by allowing low-skilled migrants to become New Zealand citizens and thus enter the trans-Tasman labour market.

- In defence, New Zealand is strategically important to Australia and Australia is strategically vital to New Zealand. Given the end of the Cold War, many Australians consider the burden of promoting stability and order in a region that includes Fiji and East Timor will increasingly devolve to Australia. Defence expenditure in Australia is expected to increase and Australians will be concerned if New Zealand is perceived to be following a neutralist and free-rider path.

- In financial markets, changes in Australian securities law passed last year disadvantage New Zealand companies wanting to raise capital in Australia. The 2000 legislation reversed earlier (1991) reforms that provided New Zealand companies with national treatment when issuing securities in Australia. While the Australian Securities and Investment Commission can exempt New Zealand companies from the new restrictions, it has been reluctant to date to do so, despite New Zealand having similar securities and prospectus disclosure requirements to Australia.

- In food standards, the Australian government is proposing legislation that would give it the unilateral power to overrule the decisions on food safety standards that are currently made by a joint body, the Australia New Zealand Food Standards Authority.

- Perhaps most significantly, in trade policy New Zealand has been excluded from initiatives to negotiate a bilateral trade agreement between Australia and the United States.

It should not be too difficult to sweep away many of these policy irritations if serious efforts were made to deepen cooperation between Australia and New Zealand.

One priority should be to remove the remaining restrictions on the free flow of capital between the two countries. As Peter Lloyd has noted, the absence of a bilateral provision guaranteeing the free movement of capital is "the most glaring omission from CER".[7] In contrast, the Treaty of Rome guarantees the 'four freedoms' of movement of goods, services, capital and labour for the members of the European Union. The North American Free Trade Agreement also has a chapter relating to foreign investment.

Other priorities include removing New Zealand's and Australia's remaining exceptions from CER for goods and services and progressing mutual recognition of business and other laws as quickly as possible.

There is also a strong case for removing the irksome requirement for passports for travel between the two countries. It is bizarre that European nationals do not require passports to travel within the European Union whereas two countries as close as Australia and New Zealand maintain passport controls. A prerequisite for such a move would probably be some alignment of immigration criteria between the two countries so that one did not become a backdoor means of entry to the other.

Why not, as some people suggest, adopt a more 'ambitious' agenda and aim for currency union or even a political union between New Zealand and Australia? After all, there are trends towards currency blocs in other parts of the world (as well as moves towards more freely floating currencies) and there is a provision in the Australian constitution for New Zealand to become part of the Australian federation.

Such ideas, however, are not panaceas and they have the potential to distract attention from more important issues. They appear to have profound economic significance whereas the economic benefits involved are not likely to be great. The 'poor-cousin' status of regions like Tasmania, southern Italy and some US states are more than ample evidence that a common currency or a political union does not necessarily equate with economic success.

Nevertheless, proposals for common currencies are worth considering. Countries that have a history of poor monetary policies may benefit from adopting the currency and, hence, monetary policies of another country. This argument would have had some relevance to New Zealand 15 years ago. However, over the past decade New Zealand's monetary policy record has been relatively good by international standards.

If New Zealand adopted the Australian or US dollar as its currency this would reduce the transaction costs incurred by investors, traders and travellers in exchanging New Zealand dollars for other currencies. The gains from adopting the US dollar would be larger because much international trade is conducted in US dollars and the real cost of capital in New Zealand would be reduced. A recent study suggested the reduction in

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7 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.

New Zealand's real interest rate could be of the order of 1.5 percentage points.[8] Adoption of the Australian dollar would not have this effect.

However, as Donald Brash, the governor of the Reserve Bank of New Zealand, has pointed out, the idea that a currency union would make New Zealanders instantly richer is nonsense:

> The fundamental driver of living standards in New Zealand is the rate at which we can improve productivity. This in turn depends on the quality of our education system, the quality of New Zealand management, the incentives provided by the tax and benefit system to work and acquire skills, attitudes to work and leisure, the pace of innovation, and so on. Currency union would have little effect on these matters.[9]

There are also some disadvantages associated with the adoption of common currencies in the face of fluctuations in international terms of trade and shifts in investor views about the prospects of different industries, regions and countries. Some countries that have tied their currencies to the US dollar have had a rough ride as it has soared in recent years. In the absence of adjustments in the exchange rate between the New Zealand and US dollars, a substantial downward adjustment in New Zealand prices and wages would probably have been necessary in the wake of the 1998 Asian crises to avoid a major recession. Moreover, recent moves that have made the New Zealand economy less flexible, including the government's higher long-term objective for government spending, its moves to re-regulate the labour market and increased regulation in other areas, do not constitute a satisfactory overall framework for operating a currency union. A forthcoming New Zealand Business Roundtable study concludes that:

> … a practical strategy for New Zealand to follow in the short term is to improve its fiscal and labour market policies, which ought to be done in any case … In the meantime New Zealand should monitor international developments in the formation of monetary unions or currency boards while exploring the attitudes of potential partner countries.

If a free trade agreement between the United States and New Zealand is negotiated (with Australia also being part of the same free trade area) the case for adopting the US dollar would become stronger for New Zealand, and perhaps for Australia as well.

Would New Zealand have anything to gain from a political union with Australia? The case for such a union has recently been argued in a book *Waltzing with Matilda* by Bob Catley of the University of Otago. Catley has suggested that:

> There would … be a substantial psychological impact for both countries and for world markets. Both countries would look as though they were making a substantial effort to get somewhere. At present, it is hard to get that impression on this side of the Tasman.[10]

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8 See Martin Lally (2000), *The Real Cost of Capital in New Zealand: Is it too high?*, New Zealand Business Roundtable, Wellington.

9 Donald Brash, 'United We Stand? The Pros and Cons of Currency Union', *Policy*, Spring 2000, Centre for Independent Studies, St Leonards, NSW.

10 Article in the *National Business Review*, 20 April 2001.

In practice it is clear that, as the larger partner, Australia would dictate the general shape of the institutions of any political union. In respect of federal elections, for example, New Zealand would probably be forced to drop its mixed member proportional (MMP) voting system and adopt Australia's version of a Westminster system. Many in the New Zealand business community would count that as a plus. On the other hand, the business community in general sets considerable store by retaining access to the resources, expertise and judicial culture of the Privy Council in respect of commercial law. What would the Australian High Court have to offer compared with the Privy Council? The potential advantages of federal systems of government are worth further consideration. However, it is easy to agree with Geoffrey Brennan, an expert in constitutional and political theory, when he writes:

> To suggest that … Australians live, constitutionally speaking, in the best of all possible worlds may be a trifle extravagant …[11]

The absence of an Australasian federation does not seem to have been a serious handicap to consideration of various proposals for harmonisation of business and other laws. There are large costs to business in complying with different regulatory requirements in the different jurisdictions in which they operate. But harmonisation should not be implemented for its own sake. The cost of bad policies can far exceed the benefits of consistency. The aim should be to have the best possible public policies, rather than necessarily replicating the policies of another country. Where Australia has the best policies New Zealand should, by all means, adopt them. But it does not make sense to adopt policies just because they are Australian.

Conclusion: the case for wider perspectives

Any sober assessment must conclude that New Zealand and Australia are simply far too small for moves toward closer economic or political integration to make much difference, by themselves, to their economic futures. New Zealand has to implement superior policies to Australia if it is not to be simply another Tasmania. Conversely, if New Zealand is merely another Tasmania, it is no spur to better economic policies in Australia. Any discussion of trans-Tasman developments needs to be set in a wider context.

The reality is that the prosperity of either country will depend fundamentally on its own decisions – its ability to develop competitive institutions and implement the major policy changes that would deliver large economic gains. Standard of living comparisons indicate that both countries are laggards, but New Zealand is very significantly worse. The problem for both countries as their relative living standards have fallen has been to shake off the 'British disease' of ossified institutions (such as state-run and protected industries and regulated labour markets), nationalised health and education systems and welfarism. Progress has been made in the past two decades – the move from protectionism to a position of close to free trade is an historic change – but the still-dominant beliefs in politics and bureaucracy, and the resistance to changing features of the welfare state that have demonstrably failed, hold both countries back. Ideas for change in the direction of less state control are still demonised as 'new right' or 'economically rationalist', despite the fact that they continue to gain ground around the world.

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[11] Geoffrey Brennan, 'The Dynamics of Constitutional Incentives', a review of *The Strategic Constitution* by Robert Cooter, *Policy*, Autumn 2001, Centre for Independent Studies, St Leonards, NSW.

New Zealand and Australia could both benefit from deeper international linkages, such as a free trade area with the United States. But once again we should be careful not to view such agreements as the answer to all our problems. Free international trade is highly desirable but it is not the only aspect of economic freedom that is important in fostering economic growth. In addition, free trade agreements are inferior to multilateral and even unilateral free trade. A free trade agreement with the United States could, however, heighten general business and investment interest by US firms in this part of the world. It might also help to lock in the gains from unilateral trade liberalisation.

The indirect benefits of new initiatives could be much more important. In the light of New Zealand's experience with CER, there might be grounds to hope that a free trade agreement with the United States would lead to more profound economic reform efforts, as well as to changes in our security relationship and to greater acceptance of the features of American culture that underpin its economic success. The most important contribution of CER was, arguably, in providing an impetus to break away from the insularity that had previously characterised economic policy in New Zealand.

Moreover, when New Zealanders looked outwards to Australia and beyond in the early 1980s, they saw Britain and the United States undertaking major economic reforms. If we look toward the same places today, we see Britain and especially the United States taking important steps to build on them. The United States has implemented major welfare reforms in recent years and the Bush administration is moving further in the direction of smaller government with cuts in income taxes and reforms to social security and education. Britain seems to be moving to reform its education and health systems by introducing improved economic incentives and more private sector participation. It should be a matter of more than casual interest to New Zealanders that continuing policy changes are occurring in countries that they know and understand. The formula for economic success is now well established – greater economic freedom and less and more focused state intervention are the crucial ingredients. The United States is once again leading the way and countries in Europe and elsewhere seem bound to follow.

Whether we like it or not we also have choices to make. We can continue our policy siesta for a few more years and allow our relative income levels to deteriorate further. If we are lucky, our previous reform efforts and growth in the world economy will save us from an absolute decline in our standard of living. Alternatively, we can get back on the track toward greater economic freedom, competition and choice, with a smaller role for the government, and raise our prospects of achieving greater prosperity. The choices we face today are less stark than those we faced in the early 1980s only because of the subsequent reform efforts. We cannot ensure future economic success by hitching a ride with Australia or even the United States. At the end of the day, New Zealand's economic success remains, as always, in our own hands.

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ARTICLE BY PHIL BARRY FOR THE
OTAGO DAILY TIMES

HOW DO WE COMPARE? NEW ZEALAND PUBLIC POLICY DIRECTIONS IN AN INTERNATIONAL CONTEXT

MAY 2001

HOW DO WE COMPARE? NEW ZEALAND PUBLIC POLICY DIRECTIONS IN AN INTERNATIONAL CONTEXT

In the early 1990s, New Zealand was seen by many as a showcase of economic policy reform. New Zealand delegates to meetings of economic policy experts would find themselves grilled by other countries on New Zealand's economic changes. The French and Greeks wanted to know about our public sector management policies, the Germans and Dutch asked about our labour market policy changes, and all countries were eager to hear about New Zealand's success in turning around what was once the most sheltered of OECD economies.

However, after 1992 New Zealand's economic reform programme largely stalled. Since late 1999 it has been in reverse. In contrast, over the last decade most, if not all, other OECD countries have continued to implement market-oriented economic reforms.

For example, in the OECD region as a whole, government expenditure as a percentage of total production (GDP) has fallen steadily during the 1990s. The most successful economies like Finland and Ireland have seen the government's share of the economy fall by 13 and 9 percentage points respectively. On the other hand, in New Zealand, central and local governments' share of total production fell in the early 1990s but has increased over the last four years and, at 41 percent, is now well above the OECD average (of 37 percent).

With steadily improving fiscal positions in most OECD countries over the last decade, countries are now actively competing with each other to cut taxes. Over the last year, 15 OECD countries have announced cuts in income tax rates. In contrast, New Zealand, alone amongst OECD countries, increased the top income tax rate in April last year.

Privatisation of state trading enterprises has become an increasingly commonplace and mainstream reform across OECD countries over the last ten years, with total proceeds in 1999 four times their level at the start of the decade. In New Zealand, however, the pace of privatisation has been erratic from the mid 1990s and it has now been formally halted.

Labour market reform was one area where New Zealand made substantial progress in the early 1990s but those reforms have now been partially reversed. Meanwhile, governments in other OECD countries with traditionally highly regulated labour markets have quietly loosened the rules, albeit in a gradual and piecemeal fashion.

The continuing trend of market-oriented reform in other OECD countries has been common to governments across the political spectrum. Centre-left governments have not only been active reformers but often amongst the boldest. For example, it is the centre-left governments of Blair in the United Kingdom, Jospin in France and Schröder in Germany that are actively privatising state assets, reforming welfare states and deregulating electricity and telecommunications markets. Of the 15 OECD governments announcing cuts in tax rates over the last year, 11 are centre-left.

In the United States, it was president Clinton, a Democrat, who led the way in reforming welfare systems. The Personal Responsibility and Work Opportunity Act of 1996 limits the use by the states of federal funds to finance benefits and provides financial incentives for states to reduce their welfare rolls. Since the passage of the Act, the number of people on welfare in the United States has declined by 55 percent, and the legislation is credited with one-third of the decline.

Echoing Clinton, the statements of Chancellor Schröder in Germany talk of "transforming the safety net of welfare entitlement into a springboard of personal responsibility". Wide-ranging reforms of the welfare system in Germany have followed.

Of course, not all policies introduced by other OECD countries over the last decade have been market-oriented. California botched its electricity reforms, France introduced the maximum 35-hour working week, and there has been 'regulatory creep' in the United Kingdom. But the overall direction of public policies in OECD countries and many others over the last decade has, without doubt, been market-oriented.

New Zealand, on the other hand, has lost its way. We were on the right track in the early 1990s, but little enough has been done since. And, as American actor and philosopher Will Rogers said, "even if you're on the right track, you'll get run over if you just sit there."

More recently, the Labour/Alliance government has not just slowed the pace of market-oriented reform but has, as it promised it would, changed the direction of economic policy. The obligations of some benefit recipients to seek work have been relaxed, ACC has been re-nationalised, school zoning has been re-introduced, the health sector has been re-centralised and, as noted, privatisation has been halted, the labour market partially re-regulated and the top income tax rate increased.

While New Zealand's overall policy settings are still within OECD norms, the direction of economic policies in New Zealand over the last year-and-a-half is not typical of other OECD countries. Rather, New Zealand stands out for the extent to which it is pursuing policies that increase the role of the government in the economy and that restrict, rather than increase, individual choice and responsibility.

Where once it looked as though New Zealand could stand out as a model of economic reform, we are now shifting back towards the middle of the class. This might not be so bad if we were a wealthy country, or if we had the luxury of a multitude of wealthy and supportive neighbours. But, the reality is that we are a small and isolated economy that must rely on its own resources and ingenuity to make its way. Given the natural disadvantages we face, we need to do better than average in framing our policy settings if we are to prosper.

CHAMBER OF COMMERCE TAURANGA REGION

ECONOMIC SUCCESS: LESSONS FROM THE WORLD

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

TAURANGA
16 MAY 2001

ECONOMIC SUCCESS: LESSONS FROM THE WORLD

The past few years have been good ones for the world economy, on almost any measure. In a large number of countries productivity and economic growth rates have been up, inflation has been low and stable, and budget deficits, debt levels and unemployment rates have come down.

It is hard to see the current slowdown in the United States lasting long. Its main origin seems to be a healthy sharemarket correction. Basic features of the US economy – low inflation, a sound budget position, technological innovation and a culture of enterprise – remain in good shape.

European economies have been performing better as their governments have been forced to accept the lessons of America's success and reduce tax rates, privatise industries, remove internal barriers to competition and begin to reform their bloated welfare states. Among the major economies, the exception to this pattern is the sad case of Japan. It is too soon to tell whether the recent change of leadership will see an end to a decade of political paralysis and bring about the structural reforms that Japan badly needs.

In general, the Asian region has bounced back after the turmoil of 1998. Critics of globalisation were quick to point to the crisis as a failure of liberal economic policies and to predict a retreat. They advocated capital restrictions and other government interventions. In fact, the main reasons for the crisis were over-regulated financial markets, weak corporate governance and political cronyism, and most governments reacted by removing controls and promoting greater transparency. Despite the recovery, it remains to be seen whether enough has been done to correct the problems on a long-term basis.

There has also been good news in many parts of the developing world, including the largest countries China and India, Russia and in much of Eastern Europe. Contrary to a widespread perception about growing inequality, the ratio of the average income of people living in the richest fifth and poorest fifth of the world narrowed over the 1990s. In addition, since a focus on poverty is more important than a concern about income gaps at a particular point in time, a recent World Bank study showed that growth has been good for the poor. The countries that have not made progress are typically those that have resisted integration into the world economy, such as North Korea, Myanmar, Libya and Cuba. The problem for them and many African countries has not been too much globalisation but not enough.

Recently there have been some exceptional individual performances. Hong Kong grew by 10.5 percent in 2000. The Irish economy grew by an estimated 10.8 percent, continuing a record of 7 percent average annual growth over the 1990s.

For many years Hong Kong has been the best example of a free economy. The Hong Kong government today describes its approach in the following terms:

> Hong Kong has established its credentials as a champion of free trade with an 'open door' policy on inward and outward investment … a freely-convertible and stable currency, a duty and tariff-free port and one of the world's most business-friendly tax systems where companies pay only 16 percent profits tax and individuals pay no more than 15 percent salaries tax.

> This pro-business environment is underpinned by the rule of law upheld by an independent judiciary, a clean administration, world-renowned anti-corruption enforcement, a level playing field for all who do business and a strong belief in 'maximum support – minimum interference' from government.[1]

Instead of a focus on income redistribution and 'closing the gaps', the Hong Kong government has directed its efforts at assisting people to rise out of poverty. As it put it in its March 2001 budget:

> A wealth gap is common among developed and developing countries. Some countries have tried to tackle this through welfarism and a high-tax policy. These measures have often created even greater problems than the ones they sought to remedy. They have brought upon their economies a series of structural problems. We must not make the same mistake. Our focus cannot be to remove this gap. Instead we must provide the poor with a basic level of social security and help them escape poverty … the key to helping the poor is to ensure sustained economic development and the creation of more job opportunities and, at the same time, to enhance their employment prospects through education and training. And, of course, we must also ensure that our people from all walks of life can move between different occupational sectors and progress to better jobs. We must all strive to excel and help our children to do the same.

I am looking forward to visiting Hong Kong later this year as a guest of the government. Hong Kong is one of the success stories of modern economic history. In the space of 30 years or so its average per capita income has moved from poverty levels to a level (adjusted for purchasing power) that is now over 25 percent higher than New Zealand's.

People with an interventionist itch studiously overlook the success of Hong Kong and promote as 'models' countries like Singapore and Ireland, which they regard as government-directed. This is an odd perspective. Singapore routinely ranks just after Hong Kong in the indexes of economic freedom: relatively speaking, it is an open, small-government economy. Singapore has had full free trade for 20 years. Ireland joined the European Union in 1973 and it has rocketed up the indexes of economic freedom in the last 10 years. Many of these countries' more interventionist policies have done more harm than good – Ireland's agricultural subsidies are a case in point. Singaporeans envy Hong Kong's more entrepreneurial culture and its more efficient use of capital. Both countries are continuing to reduce unnecessary government involvement in their economies. Ireland has cut its government spending ratio from over 50 percent of gross domestic product in the 1980s to a level now approaching 25 percent. (The ratio for Singapore is around 17 percent whereas for New Zealand it is around 40 percent – the average New Zealander spends two days of every working week working for the government.) Both Singapore and Ireland have been actively privatising government-owned businesses.

Of course, Hong Kong is far from perfect: commentators often note, for example, that the housing market in Hong Kong is dominated by the government, which also owns the post office, and that those are two bits of its economy that do not work well. It may also lose some of its economic dynamism over time under the influence of China. But

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1 'Hong Kong: Asia's Premier International City', Government of Hong Kong, 2000.

Hong Kong, Singapore and Ireland are all small economies that have prospered essentially by promoting economic freedom.

Like the majority of other countries that have pursued market-oriented economic policies over the past two decades, New Zealand has also improved its economic performance. It is simply not credible for those who speak of New Zealand's mediocre long-term economic record to fail to acknowledge the turnaround in the mid-1990s. Annual economic growth averaged over 4 percent in the five years to 1997, and the fall in the unemployment rate from 11 percent to 6 percent was the fastest in the Organisation for Economic Cooperation and Development area. The expansion from the third quarter of 1992 to the fourth quarter of 1997 was the most enduring and consistent of the last three decades. This was far more than five minutes of sunshine.

Since around 1997, however, economic growth has fallen away, to an average annual rate of a bit over 2 percent. The outlook is for a similar lacklustre performance. This should not surprise anyone. Since the early 1990s the New Zealand Business Roundtable (NZBR) and other commentators have been expressing concern that governments were losing their appetite for reform, and reverting to habits of excessive government spending and creeping regulation. It is hard to think of any major initiatives to promote growth since the Employment Contracts Act of 1991 and the Fiscal Responsibility Act of 1994 – now almost ancient history in a fast-changing world.

The current Labour/Alliance government has emphasised redistribution not wealth creation. Most of its economic policy changes have been seen as harmful for business; indeed the government itself has argued for them on social grounds and has not sought to make a case that they have been positive for growth. Its more recent focus on business development is welcome, but it has yet to deliver on any significant initiatives. Its failure to make any meaningful amendments to the Resource Management Act 1991 in the legislation before the house is not a good sign. Moreover, its unwillingness to cut spending in some areas to offset increases in others heightens concern that its most business-friendly policy to date, a reasonably firm fiscal stance, could be at risk.

This analysis of the reasons for New Zealand's recent economic rise and decline is disputed by some. The *New Zealand Herald*, for example, has consistently maintained that New Zealand has "one of the world's most welcoming environments"[2] and that poor business management rather than deteriorating public policies is to blame for the slide.

I think the *New Zealand Herald* is wrong on both counts. New Zealand enjoyed a rating of ninth position in surveys of international competitiveness in 1995; it has now fallen to twenty-first place. The *New Zealand Herald* recently noted that New Zealand still ranks third in the ratings of economic freedom; it overlooked that the latest rankings are based on 1999 data and will almost certainly fall in response to recent policy changes. Investors, entrepreneurs and skilled professionals look forward, not backward, in assessing a country's attractiveness: for some years now they have seen New Zealand as a less attractive country, as evidenced by the fall-off in international investor interest, a lower credit rating, the decline in the currency and the renewed outflow of people.

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2 *New Zealand Herald*, 27 April 2001.

Similarly, as a recent paper by Bryce Wilkinson for the NZBR shows, it is idle to blame New Zealand's fortunes on general business mismanagement; major losses of shareholder value have been concentrated in a handful of companies. Academic research suggests that 70–80 percent of the share price of a company is the result of macroeconomic, industry and other factors that are generally beyond the control of management. In the economic stakes it is the rules of the game not the incumbent players that matter most – worldwide competition in the market for managers tends to ensure roughly equivalent competence for given rates of remuneration. Would any serious commentator blame Japan's plight in the last decade on a decline in business skills?

Given the worldwide trends towards market-oriented policies, critics of New Zealand's earlier reforms have struggled to come up with coherent alternative strategies. One alternative viewpoint is that New Zealand should have followed a path more like that of Australia. Again this logic seems dubious. Most commentators put Australia's improved economic performance down to the structural reforms that began in earnest in 1983, and which, overall, are remarkably similar to those of New Zealand. The main differences were the Keynesianism of the Hawke–Keating government and the associated incomes policy Accord that New Zealand critics favoured in the 1980s. These have long since been discredited and have disappeared as features of Australian policy. One can endlessly debate differences of timing and sequencing between the New Zealand and Australian reform programmes, but these have little relevance to the future. The issue is what New Zealand should do today. In my view Australia's overall policy settings, while not outstanding, are now better than New Zealand's; I would be happy if New Zealand were 'more like Australia'.

Regrettably, Australia also looks likely to suffer a loss of reform momentum. Its politicians and business leaders have failed adequately to explain to the public the necessity of ongoing adaptation to changes in the global marketplace. As the Western Australian Chamber of Commerce put it in a recent publication:

> It is a matter for grave concern that relatively few in public life, and outside politics, have sought to challenge this state of affairs. The academic crusaders for economic liberalism of a generation ago are now largely silent … and it is difficult to find more than a handful of reputable media figures willing to promote the cause. The economic reform agenda is in danger of fading away – and with it, our chances of maximising sustained long-term prosperity.

In early May the NZBR published a study by economist Phil Barry entitled *How Do We Compare?*: *New Zealand's Public Policy Directions in an International Context*. Its purpose was to examine the direction of policies in other OECD countries since the early 1990s and to ask whether, like New Zealand, they had experienced a slowdown in the pace or a reversal in the direction of economic reform. In every area examined – fiscal policy, trade liberalisation, deregulation, labour markets, privatisation and social policies – the study concluded this was not the case.

Perhaps the most striking difference is in the area of government spending. New Zealand stands out as one of the few OECD countries where the overall government spending share of national income has not fallen in recent years, contrary to earlier targets. The government's move to raise the long-term objective for central government spending from 30 to 35 percent of GDP is probably its most important economic decision to date. Total government spending is now 10 percent above the

OECD average, according to OECD estimates. Because government spending is the best measure of the overall tax burden, New Zealand ranks as a high-tax country, even by OECD standards. High levels of spending and taxation damage economic growth. The failure to control government spending was the worst feature of the economic mismanagement of the Muldoon era – remember the 'great spendthrift' – and since the Bolger/Richardson government the bad old habits have returned. Anyone who holds up Singapore and Ireland as economic models should be arguing in the first instance for less government spending and lower taxes.

Many of the earlier critics of New Zealand's reforms now acknowledge that changes were necessary, and most of the changes are no longer in dispute. The minister of finance, Dr Michael Cullen, told a Japanese journalist last year:

> Fundamentally we will not change our open market policies. It is not necessary. The structural reforms produced great results. Most privatised corporations have been successful. What the current government is doing now is not because the structural reforms were wrong, but because we want to adopt a pragmatic approach to do better.[3]

There is nothing wrong with being pragmatic, but is it being pragmatic, for example, to recognise that privatisation has generally been a success but to call a halt to it, as the government has, on "philosophical" grounds, and to set up a new state bank? And no country can rest on its laurels in a world that keeps changing. New Zealand's tax reforms in the 1980s gave us a comparative advantage over many countries, but others have now caught up. As American actor and philosopher Will Rogers said, "even if you're on the right track you'll get run over if you just sit there". This year the United States has again been showing the way with the Bush administration taking bold initiatives to constrain government spending, cut taxes, deregulate, abandon the economically damaging Kyoto Protocol and build on the welfare reform achievements of the Clinton administration. European and other countries will be under pressure to follow suit.

Discussing Australia's place in the international economy, the respected Australian economist Kym Anderson recently noted that one of the challenges ahead for Australia, if it is to reverse its slide down the per capita income ladder, is to *keep on* opening up and reforming *faster* than its trading partners. Dr Cullen has agreed with the view that given New Zealand's size and remoteness, it has to have better public policies than other countries if it is to progress. The United States and other leading countries must be our benchmarks.

The problem, as I see it, is the gap between these commendable sentiments and the lessons of economic success abroad. Phil Barry concluded that, while New Zealand's overall policy settings are still within OECD norms, New Zealand stands out for the extent to which it is pursuing policies that increase the role of government in the economy and that restrict, rather than increase, individual choice and responsibility. If New Zealand's policies are only of average quality by OECD standards, our economic performance is unlikely to be more than the OECD average – say 2–3 percent growth a year – and it could be less given our natural disadvantages. If we let our policy rankings go backwards, the outlook will be weaker again.

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3 Gentaro, Yoshino, Nihon Keizai Shimbun, 'Lessons from New Zealand's structural reform' speech to the New Zealand Studies Association, Tokyo, December 2000.

Right now the outlook for New Zealand is far from robust. Despite a very favourable combination of circumstances, the economy has only been growing by 2–3 percent over the past 18 months. The increase in export volume growth has been disappointing – most of the increase in export values has been due to price changes and the lower currency – and may have slowed to less than 1 percent year-on-year in the last quarter. The Treasury's economic forecasts have consistently been too optimistic over the past couple of years and look likely to be revised downwards again in the May budget.

If one were to give an economic interpretation of the government's strategy to date, it would be that it has focused on cutting real wages through the currency depreciation – wages have not kept pace with import and export price increases – rather than raising productivity. This is not a sustainable long-term route to achieving international competitiveness and export success, as the continuing falls in the international competitiveness rankings show. Strong economies are not built on weak currencies or low wages. Only productivity improvements based on incentives to work and invest, low taxes, stable prices, secure property rights and sensible regulatory policies underpin long-term increases in living standards. Broadly speaking, that was the environment that produced the so-called 'golden age' in the world economy in the 1950s and '60s. Much of the world is returning to the norms of that environment, although many countries have a long way to go. This largely explains the improvements in the international economy in recent years, and why the world seems set for continuing market-driven growth.

Against this background, the government's recent emphasis on growth-promoting initiatives is welcome, and the business community needs to engage with it constructively on projects such as the goal of reducing business compliance costs. If this exercise is to be meaningful it must involve revisiting decisions already taken – the increase in the top tax rate, for example, required 47 pages of new tax law. But the lessons from the rest of the world seem to be that more than a change of emphasis is necessary if New Zealand is to enjoy the economic success of other countries. Phil Barry's research suggests that since the government 'reset the compass', New Zealand has been headed in a different direction from most other countries. And while some may argue that the rest of the world is out of step rather than New Zealand, operating on that basis would seem to be a risky gamble with New Zealand's future.

HUTT ROTARY CLUB

THE BRAIN DRAIN

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

LOWER HUTT
2 MAY 2001

THE BRAIN DRAIN

There are a number of indicators of the long-run performance of an economy – its record of delivering improvements in material living standards to its citizens.

The most familiar is the rate of growth of real gross domestic product: the increase in the volume of goods and services produced in the economy. Expressed in per capita terms, real GDP is a rough measure of the standard of living.

As is well known, New Zealand's long-term growth performance has been poor. Over the period from 1960 to 1997, real GDP per capita in Organisation for Economic Cooperation and Development countries grew, in total, by 139 percent. In comparison, real GDP per capita in New Zealand increased over the same period by just 60 percent.

The record was better for a period in the last decade. Since the end of the recession in the early 1990s, annual growth in real output (not per capita) averaged 4 percent for five years and around 3 percent for the past decade. After the expansion ended in 1997, it has fallen away to a bit over 2 percent.

Another fundamental indicator of economic performance is growth in productivity, which is usually the only basis for sustained growth in living standards. New Zealand's long-term productivity growth rate has been weak. Again, the combined productivity of our capital and labour resources (total factor productivity) increased with better economic policies in the mid-1990s (to around 1.5 percent a year). This increase was not reflected in measured labour productivity growth because many low-skilled people, who were not in employment or who were unemployed, took up work.

A third indicator of economic performance is the foreign exchange rate. Back in the late 1960s, the New Zealand dollar was worth over US$1.30. It had fallen to just over US 50 cents by 1992, rose to US 70 cents by late 1996, and has since fallen to around US 40 cents. The trend against the currencies of other well-performing economies has been similar. Like it or not, a weak currency is a vote of no confidence in a country's economic management, particularly in relation to its indebtedness and its ability to maintain international competitiveness.

Another indicator of how well a country is performing, which I want to examine more closely, is migration – the inflows and outflows of people.

The long-term picture here mirrors other economic indicators. Broadly speaking, the 1960s and early 1970s were periods of net inflows of permanent and long-term migrants. There were large net outflows in the late 1970s and throughout the 1980s. In the mid-1990s there was a turnaround: net inflows in the four years to 1997 averaged over 20,000 annually. Since then the pattern has reversed: in the last three years there has been an average outflow of around 10,000, and the total in the March year just ended was 12,600.

Much of the commentary on migration focuses on the net movements of people. It is also relevant to consider the gross statistics. Since 1996, the number of permanent and long-term departures has risen from just over 50,000 to around 79,000 (March years). In the same period, total arrivals have fallen from 80,000 to 66,500. Overall, the more liberal immigration policies of the 1990s have been a good thing, attracting many talented and enterprising people to live and work in New Zealand. However, it would not be a healthy situation for New Zealand to be minimising migration losses simply by lowering entry criteria, or if migrants were coming here merely to gain backdoor entry to Australia. Moreover, the gains from immigration are often long term as settlement and adaptation to a new country take time. Hence the increase in the total number of New Zealanders departing, regardless of the arrivals pattern, may be a cause for concern.

Taken together with other indicators of a weaker economic performance, I think the recent trends are worrying. This is not just a story of the 18 months since the change of government: in the year to March 1998, net inflows had already fallen to a mere 2,500. Recall that Jim Anderton was referring to this development when he expressed the hope immediately after the election that young New Zealanders who had left the country would return. Movements of people typically reflect the relative attractiveness of a country in terms of earnings and employment opportunities. The net outflows of people in recent years, along with the fall-off in foreign investor interest in New Zealand, tell us that the country has become less attractive.

It is interesting to contrast New Zealand's migration experience with that of another small country, Ireland. For many years up to the 1990s, Ireland typically suffered an exodus of people. When I visited the country a couple of years ago, I was told the Irish used to joke in the 1980s about whether Dublin airport could handle the number of people who wanted to leave. After Ireland knuckled down and started reforming its economy in the late 1980s very much along New Zealand lines, it saw a dramatic turnaround in migration patterns. Large numbers of returning Irish and other immigrants have been added to the workforce, yet the unemployment rate is now falling towards 3 percent. Ireland's prosperity looks set to continue as, contrary to New Zealand, it has pressed on year by year with market-oriented economic reforms.

At this point is it worth pausing to consider whether New Zealand's recent migration patterns are necessarily a bad thing. Three counter-arguments are sometimes made. I have some sympathy for the first but I think the other two are dubious.

The first argument is that a concern about migration losses reflects an outdated nationalism, particularly in today's interconnected world. We want New Zealanders to get ahead, to do the best for themselves and their families. Does it matter if Boyd Swinburn, Brad Butterworth, Kiri te Kanawa, Alan Gibbs or the next generation of entrepreneurs can be more productive elsewhere and take their skills and money offshore?

I can relate to that argument. Two of my sons are in Boston and San Francisco embarked on exciting business careers. As parents, many of us want our children to be citizens of the world. With cheap transport and communications it is easy for many families to stay in touch. But there are less attractive features to this scenario. Not everyone will have such opportunities: those who will not will typically be the less skilled, people dependent on welfare, the old and the otherwise immobile. Parents worry about how often they will see their children. Also, people are typically tax-receivers when young and old, and taxpayers in between. If people leave in their taxpaying years and stay away for lengthy periods, the position of those dependent on taxpayer support will become tenuous.

A second reason advanced to suggest that the recent outflows are not a concern is that they are no more than the usual departures of New Zealanders embarking on their overseas experience (OE). I believe experience working or spending time overseas is invaluable to residents of a small, isolated country: I learned an enormous amount living in Europe for four years and spending five years on the board of a major

Australian company. But I suspect that what we are seeing today, in many cases, is different from the traditional OE.

Two things in particular stand out. One is that the era of globalisation is leading to many more opportunities for New Zealanders to work abroad. As labour markets have tightened round the world, industries in many countries have become desperate for skills and governments have responded by easing immigration rules and fast-tracking work permits. There are now over a million expatriates in London; Silicon Valley teems with Indian entrepreneurs; and there are vast numbers of British engineers in the German motor vehicle industry. International firms are moving New Zealand personnel around their operations. It is not just information technology staff but nurses, teachers and many others who are being headhunted: New Zealanders have good reputations as workers abroad. Competitor nations will be increasingly seeking working age people as their populations age, and the challenge for New Zealand to attract and retain people is likely to become harder.

In addition, the opportunity gaps between New Zealand and many other countries are widening, accentuated by the currency decline. Average per capita incomes in Australia are now around 40 percent higher than in New Zealand; in the United States they are twice as high. United Sates remuneration packages of US$100,000 for twenty-something lawyers, computer professionals or MBA graduates are commonplace: at today's exchange rate, that is equivalent to a New Zealand salary of $250,000. Even allowing for higher costs of living, that difference exerts a powerful pull in earning terms alone, and in many places lifestyle and cultural attractions rank with those of New Zealand. Also, high earners abroad do not have to put up with local attitudes towards those in top pay brackets.

The net result, according to many accounts, is that New Zealanders are leaving, staying away for longer periods, and, in many cases, are less certain about returning. As they move up the earnings ladder, reach more senior positions that are less plentiful in New Zealand, and settle down and start families, there is a risk that fewer will return than in the past. Some have suggested that there may be ways of harnessing the potential of New Zealanders abroad to the country's benefit; while there are no doubt possibilities, none of significance has been identified so far.

A third argument put forward is that we are not really seeing a 'brain drain' because the outflow is across all skill levels, not concentrated in higher skill managerial, professional and other categories. This appears to be true, at least as far as departures to Australia are concerned; those going further afield tend to be higher skilled. But I suggest there is an element of intellectual snobbery in regarding the brain drain as confined to those with higher qualifications: a sustained loss of any category of enterprising people with 'get up and go' should be of concern. The act of migrating suggests they may have more initiative, and be more willing to take risks, than counterparts who stay put in their native country. From the point of view of wealth creation, the most serious losses may be of entrepreneurs, who are often not people with advanced qualifications: both Bill Gates and Larry Ellison are college dropouts.

My conclusion is that, at least from a national interest point of view, there is no good reason to be complacent about the current outflows of people. Right now many kinds of skill shortages are being reported even though growth is hardly stellar. A South Island firm is experiencing a serious shortage of truck drivers, for example, and is contemplating advertising in Australia. No doubt there will be variations in the pattern: for example, departures may fall off in the period ahead as activity slows in major economies or increase when New Zealand next goes into recession. However, the trends toward higher sustainable growth and lower unemployment that we have seen around the world in recent years seem likely to resume as countries continue to improve their economic policies. The gravitational pull of mobile capital and labour towards more attractive locations and away from less attractive locations seems likely to remain strong.

There is an irony about these developments. On the one hand, the continuing reductions in the cost of information, transport and communications are lowering the disadvantages of remote locations. Our successful entrepreneurs in industries such as software, fashion and furniture show that it is possible to do business globally from New Zealand.

On the other hand, there are powerful forces at work that are leading activity and people to concentrate in fewer, denser places closer to larger consumer markets. Recent economic research suggests that productivity and wages are higher in big cities, labour markets offer improved matching and greater security for workers because of the pool of employment opportunities, and there is more innovation and opportunities for specialisation with attendant efficiency gains.

To understand the challenges New Zealand is facing, it is worth watching developments in Australia. Writing recently in the *Australian Financial Review*, the highly respected business commentator Alan Kohler said:

> Australia's place is increasingly peripheral: no replacement has been found for its leadership in basic commodities; very few Australian companies have successfully built global businesses … [After News Corporation, Rio Tinto and National Australia Bank, the list of Australian corporations either moving abroad or thinking about it] is beginning to look like a list of the ASX Top 20: AMP, Amcor, AXA Asia, BHP, Brambles, Cochlear, CSL, CSR, Foster's, James Hardie, Lend Lease … Globalisation is without doubt the number one issue for Australian businesses as the new century begins and the difficulty of running a global business from Australia is the number one problem associated with it … The rest of the world is just too far away and our own consumer and capital markets are too small.

These challenges are magnified for smaller peripheral economies, such as South Australia, Tasmania and, of course, New Zealand. Since 1972 Tasmania has had net migration losses to the rest of Australia in all but six years. It is now actually losing population and is projected to continue to do so. On top of its natural disadvantages of distance it has compounded its problems with over-government, heavy taxes on business, and excessive environmental and industry regulation.

There is nothing New Zealand can do about its location, international technological innovations, or the advantages of major centres of population. To offset these factors it has to strive to be superior in the skills and effort of its workforce, the quality of its business management and, above all, in its public policies. Modern economic growth is mainly about brain power and sound policy. Investment capital and entrepreneurial talent will flow toward economies with low taxes, secure property rights, sound money and sensible regulatory policies. In contrast, when these factors are absent, people will find more attractive environments elsewhere. The quality of public policies is the key factor within the control of governments and the electorate, and it decisively influences whether countries prosper or languish.

A very strong case can be made that developments in public policy in recent years have not helped New Zealand meet the challenges and opportunities of globalisation. After the 1990–93 parliamentary term, the momentum of economic reform fell away, and the current government has changed the direction of economic policy ("reset the compass"), as it promised it would. While most OECD countries, and many others, are continuing with market-oriented economic reforms, New Zealand is on another path.

It is difficult, however, to detect in the government's programme a strategy that will improve the long-term indicators of economic performance that I mentioned at the outset, including the migration outflows. On the government's own projections, the economy is set to grow by only 2–3 percent in the years ahead, and the risks of a worse performance are significant. That signals continuing relative decline. In respect of migration, the increase in the top tax rate has heightened the incentive for talented people to leave: in addition to making it more costly for firms to retain them, it is an unfortunate psychological signal that effort and risk-taking are not highly valued. In respect of hopes for 'new economy' developments, the changes to employment law are a step backwards. They have made it more difficult and costly to lay off workers, which discourages firms from hiring in the first place. A key feature of Silicon Valley is the ease of hiring and firing, which makes innovative start-up ventures much less risky.

I doubt that any single factor is decisive in generating or arresting a brain drain. Attributing recent trends to student loans, for example, strikes me as implausible: the costs of university tuition and levels of student borrowing are often much higher in the United States than New Zealand, yet the United States stands out as a country that is not suffering a loss of internationally sought-after talent. Rather, I suspect people make decisions to migrate on the basis of push and pull factors, rewards and opportunities, in which an overall judgment of whether a country is going in the right direction is an important element. They give weight to economic factors, but also to cultural attitudes (including to entrepreneurship and wealth creation), the quality of political life, and whether policies affecting today's multi-ethnic societies are promoting harmony or divisiveness.

It is a matter of democratic choice whether New Zealand pursues policies that result in strong economic growth and attractive living and working conditions. As the turnaround in net migration in New Zealand in the 1990s and the experience of countries like Ireland shows, there is no reason why a small economy cannot transform its outlook by 'wising up' with its public policies. Equally, however, as the experience of Tasmania shows, natural disadvantages coupled with persistent mismanagement can make a brain drain endemic. Tasmanians are not going on a traditional OE.

New Zealanders may choose to vote for the quiet life, to avoid the continuing adjustments needed to cope with globalisation, and to reject the lessons of international economic success. A majority may decide to opt for redistributive rather than wealth-creating policies, and seek to tax the enterprising and those with money to invest. But if they do, in the face of all the evidence about how today's economic world works, they should not complain when the most productive vote with their money and their feet, reducing the tax base for those who remain. Actions have consequences, some of which can be unfortunate.

ARTICLE BY ROGER KERR FOR
THE INDEPENDENT

ARE THE ECONOMIC GAPS SET TO CLOSE OR GROW?

DECEMBER 2000

ARE THE ECONOMIC GAPS SET TO CLOSE OR GROW?

The path of the economy in 2000 has turned out to be rather different from that expected by the government at the end of 1999.

The incoming government expressed concerns that the economy was growing too strongly. The minister of finance, Michael Cullen, asserted that the fall of the New Zealand dollar to below US50 cents would not be sustained. The Treasury was forecasting GDP to grow by 3.5 percent in the year to March 2001. The government expected a downgrade in New Zealand's credit rating.

Within a few months it was apparent that growth was close to stalling, the dollar subsequently dipped below US40 cents – unquestionably the main economic event of the year – the growth forecast has been scaled back to around 2.5 percent, and the credit rating is intact for now.

These events occurred against the background of a very favourable world economy. The currency depreciation owed something to the strong US dollar and the rise in oil prices, but despite these factors most major economies grew strongly. The weakening of New Zealand's economic framework in recent years, which was apparent at the time of the Asian downturn, was again exposed.

As the year ends, local business confidence has become less negative and growth appears to be picking up, led by increased profitability and output in the export sector.

This reflects a welcome reallocation of resources into the traded goods sector, which should help reduce the uncomfortably high current account deficit. But the currency depreciation will only 'stick' in the short term if workers accept lower real wages. Beyond the short term, export industries need to realise that real exchange rates oscillate around a long-run average so that periods below average are followed by periods above it. Healthy economies tend to have strong real exchange rates sustained by rapid productivity gains.

Key issues for international competitiveness and economic growth will be whether a return to a more average real exchange rate level occurs through a moderately appreciating nominal exchange rate, productivity improvements and fiscal restraint, or whether excessive growth in real wages and other costs erodes competitiveness and/or forces a monetary tightening.

The ballooning of the current account deficit in the second half of the 1990s was just one of many indicators that New Zealand had lost ground for several years. As *The Economist* put it recently, New Zealand is often portrayed as undergoing a decade-and-a-half of non-stop change. In fact, reform occurred in two brief waves – 1984–87 and 1990–91 – under Labour and National respectively. "In both cases, after an initial spurt, reforms stalled during [these] governments' second term in office".

Against this background, the present government's claim that it is 'rebalancing' earlier reform 'excesses' and following more mainstream policies is difficult to understand. There is no indication that governments around the world are slackening in their reform efforts.

In its recent report on New Zealand, the OECD criticised a range of decisions including a risky budgetary position, the increase in the top tax rate, the halt to privatisation, the tariff freeze, relaxed welfare rules, the re-regulation of the labour market and other heavier-handed regulation. The report is the responsibility of OECD member governments, not the secretariat: it is a litmus test not of cutting-edge economic thinking but of the consensus of official opinion in leading countries around the world today.

When the German government is privatising its post office, the British Labour government its air traffic control system and Sweden some of its hospitals, it is clear that New Zealand is marching to a different drum. None of our political parties is advocating such steps.

The government has described the essence of its policies as redistributive and more 'hands-on'. A major decision has been to increase by 17 percent (from 30 to 35 percent of GDP) the long-run target for government spending at a time when most OECD countries are striving to reduce government spending, tax and regulatory burdens.

In today's global economy the costs of decisions by governments to turn their backs on mainstream directions can be high. International investors are watching New Zealand's experiment with scepticism and are reducing their exposure to the country. The turnaround in net migration after the inflows of the mid-1990s shows no signs of abating as opportunities for talented people look more attractive elsewhere. Given current policy settings, New Zealand is poorly placed to cope with a major external economic downturn.

Recently, the government has focused more positively on the economy and has been stressing the realities of globalisation. These developments are welcome. The economic debate is not about whether it has a mandate to implement unorthodox policies but whether they will serve New Zealand's interests.

The most important mandate sought by the government was to improve New Zealand's economic performance. It promoted goals of 4 percent average annual economic growth and a 3 percent unemployment rate.

The government's own projections suggest that the attainment of these goals is not in sight. It is doubtful that they will be achieved without further reconsideration of policy directions.

As *The Economist* put it, New Zealand should "press on with reform, as most other countries around the world are now doing". Michael Cullen has acknowledged that to offset its natural disadvantages, New Zealand needs to have better economic policies than other countries if it is to be an attractive location for investment and for skilled workers.

In the absence of such policies, the income gaps between New Zealand and other better-performing countries are not likely to close. They are likely to widen.

FISCAL POLICY AND THE PUBLIC SECTOR

ARTICLE BY WINTON BATES

THE HIGH COSTS OF BIG GOVERNMENT

AUGUST 2001

THE HIGH COSTS OF BIG GOVERNMENT

In the industrialised world governments grew rapidly during the twentieth century. From 1913 to 1990 government spending increased, on average, from about 13 to 45 percent of GDP. Especially in the period 1960 to 1980 big government got even bigger.

Faced with the growth in the size of governments, economists began to assess the impact on economic performance. In the 1940s, John Maynard Keynes agreed with fellow economist Colin Clark who suggested that the maximum tax level an economy could sustain was about 25 percent of national product.

During the twentieth century in New Zealand the increase in the public spending ratio was broadly similar to the OECD average. New Zealand reduced its government spending ratio in the early 1990s, but did not maintain this trend. Since 1996, New Zealand's public spending ratio has risen while the OECD average has declined. With total government spending at nearly 40 percent of GDP, New Zealand, by international standards, is a big government, welfare state.

Although big government imposes economic costs that affect the well-being of everyone, these costs are only one of several factors that should be taken into account in considering the size of government. The adverse effects of big government on personal freedom, social cohesion and civil society may well be more important than the adverse economic effects.

If there are any benefits of big government these should also be considered. But the view that big government produces superior social outcomes does not stand up to close scrutiny. As might be expected, industrialised countries with big governments (high government spending as a percentage of GDP tend to have higher spending on health, education and transfer payments than those with small governments. However, research by IMF economists (Vito Tanzi and Ludger Schuknecht) indicates that performance indicators for health and education are quite similar for countries with both big and small governments. Countries with big governments have performed only marginally better in terms of the proportion of national income going to the poorest households.

In addition to total government spending, there are several other important aspects of the size of government. These include the range of services produced, the extent of government regulation, government spending on goods and services, and redistribution through transfer payments.

During the twentieth century, government involvement in production activities in New Zealand, as in many other industrialised countries, extended far beyond the limited range of services (public goods) that markets are unable to supply efficiently. Since the mid-1980s this situation has been corrected to some extent by privatisations, which have resulted in substantial improvements in productivity. Nevertheless, the government remains heavily involved in ownership of electricity generation and distribution, water utilities, health care facilities, main roads, ports and airports where it has disadvantages relative to private suppliers.

As a result of its economic reforms since the mid-1980s, New Zealand can claim to have substantially reduced the costs of economic regulation – affecting such things as prices, and conditions of entry and exit from industries. Regulatory reforms were largely responsible for the substantial improvements that occurred in New Zealand's economic freedom rating. Research on the relationship between economic freedom and economic growth suggests that, in the absence of the reforms, New Zealand's recent growth performance would be a lot worse than it has been.

However, the limited information available on trends in social regulation in New Zealand – including environmental, health and safety regulation – suggests that the costs of complying with that regulation continued to rise during the 1980s and 1990s.

There is substantial evidence that high government consumption spending – which consists mainly of the wages of public sector employees – has adverse effects on economic growth. Reductions in government spending during the reforms in New Zealand only pared back about one-third of the 70 percent increase in government consumption as a percentage of GDP that occurred in the period from 1960 to 1980.

Redistribution of income by government can have adverse effects on the economic incentives of intended beneficiaries as well as taxpayers. There is evidence that these effects are substantial for some government spending programmes. The redistribution activities of government also tend to change habits and norms in ways that impact adversely on economic growth, for example, by encouraging welfare dependency and diversion of resources to lobbying for government handouts.

There are substantial deadweight costs associated with the taxes required to fund high levels of government spending. Available evidence suggests that, as a result of these deadweight costs, additional government spending in New Zealand would have to yield a benefit to citizens of more than $1.50 for each additional $1 spent for it to be worthwhile.

Deadweight costs of this magnitude imply that maintaining government spending at about 40 percent of GDP reduces average income levels of New Zealanders by about 5 percent below levels that would prevail with government spending of 30 percent of GDP, the level in the United States. Econometric analysis for OECD countries suggests that this estimate of the reduction in incomes resulting from big government is too low. There are good reasons to expect that smaller government would result in an additional ongoing improvement in New Zealand's economic growth performance.

The trend toward smaller government in OECD countries looks set to continue in the years ahead. Although this will be good for the world economy, countries that seek to maintain high government spending and high tax rates are likely to find it increasingly difficult to attract the internationally mobile resources needed to keep pace with high income countries. The future costs of maintaining big government in New Zealand are likely to include a further decline in living standards relative to those enjoyed in high-income countries.

NEW ZEALAND AUTOMOBILE ASSOCIATION
ANNUAL CONFERENCE

CARS ARE A GOOD THING

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

AUCKLAND
30 MARCH 2001

CARS ARE A GOOD THING

It is interesting to look back on changes in motoring and roading in New Zealand over the past 30 years. There are some ironies in the story.

I remember when I was with Foreign Affairs in the late 1960s handling a visit by a Belgian journalist as part of New Zealand's campaign to maintain access to European markets. The journalist observed in a subsequent article that New Zealand had the best roads in the world and the worst cars – he described them as "patched-up old bombs" ("de vieux tacots rafistolés").

The state of our vehicle fleet and the state of our roads had much to do with the policies of post-war governments.

In the 1950s, New Zealand was still a high-income country. The *New Zealand Official 1990 Yearbook* tells us that "New Zealanders at that stage were second only to Americans in levels of vehicle ownership". But governments maintained and extended the protection granted to both vehicle assembly and component manufacturing as part of the raft of economically debilitating fortress New Zealand policies. During the 1950s and 1960s tight import restrictions limited the availability of both built-up and completely-knocked-down (ckd) vehicles. The 1970s saw the number of separate car assembly plants grow from 10 to a high of 16 – for a country with a population of around three million.

It was the high cost of cars in this protected environment that led to the large number of aged and sometimes unsafe vehicles on the road. From the late 1970s, governments moved slowly to reduce high levels of protection, car assemblers and component manufacturers improved their efficiency, and imports – including second-hand cars from Japan – became more freely available. The process took a painfully long time – uncompetitive car assembly operations in Ireland and Singapore closed in the 1970s as these countries opened up their markets. Today, however, New Zealanders can buy any car they want, cars are far more affordable for low-income people, the vehicle fleet is more modern, safe and fuel efficient – and yet some people, such as the Greens, still oppose free trade.

By contrast to the state of the vehicle stock 30 years ago, there was a Rolls Royce aspect to New Zealand roading. Of course that was not always the case – road conditions were often primitive in the early years of motoring. In the context of current discussions about road pricing, it is interesting to note that toll roads were a common feature of New Zealand roading up to the 1920s, and were very successful. Like many other industries, however, roading was effectively nationalised, and in the 1950s and 1960s extravagant amounts were spent on roads. Pork-barrelling led to much unused capacity around the country in the form of multi-laned bridges and highways. In a paper I gave to a roading symposium in 1980 when I was working for the Treasury, I reported a study that showed benefit/cost ratios for a sample of state highway projects ranging from 1.07:1 down to 0.38:1. A ratio of 0.38:1 indicates that costs exceed benefits by a factor approaching three. New Zealand was wasting resources in roading in the same way as it was wasting resources on low-return Think Big projects and subsidised agricultural production.

Ironically, however, the wheel has come full circle. Instead of reining in spending on uneconomic roading projects but continuing to build roads where increases in capacity were justified by demand – as with the Auckland motorway network – governments fell prey to an anti-motoring and anti-roads mindset. A big factor in this was the oil shocks and other environmental scares of the 1970s that led to follies such as carless days and, ultimately, to Think Big. In the belief that the world was running out of fossil fuels, politicians and lobby groups argued for public passenger transport solutions, and more recently for 'smart growth' planning strategies to restrict so-called 'urban sprawl'. From the early 1990s, an additional factor has been the fear of global warming from greenhouse gas emissions.

The result of these influences has been a serious under-investment in roading, at least if we can believe the use by Transfund New Zealand of a benefit/cost cut-off ratio of 3:1 for roading projects today. On this basis resources are being wastefully misallocated, just as they were at the time New Zealand was over-investing in roading. Demand for road space is also being distorted by the lack of proper pricing, especially in the major centres, causing an additional set of economic losses.

Around the world there has been a shift in policies and politics as the environmental fears of the 1970s proved largely groundless, although this has been slow to happen in New Zealand. *The Economist* noted in a survey of energy last month that "the idea of hydrocarbon scarcity that once haunted policy debates is now largely defunct". Oil prices are still well below 1970s levels in real terms, fossil fuel reserves and alternative energy sources are plentiful, and energy efficiency continues to improve. Because of inventions like the catalytic converter, unleaded petrol and other technologies, cars pollute much less nowadays and are much more fuel efficient. Driving is also safer today than ever before. These trends will almost certainly continue as hybrid cars and fuel cell technology reach the mass market in the relatively near future.

The international change in social attitudes is apparent from an article headed 'German Greens embrace the car' that appeared in the *Financial Times* of 28 May 2000. It reported that:

> After years battling against motorways, petrol-guzzling motorists and anything that slows up a bicycle, Germany's environmentalist Green Party has taken a step towards ending its rage against cars.
>
> A strategy paper by senior figures in the party, junior member of Chancellor Gerhard Schröder's coalition, has acknowledged that any attempt to limit individual mobility simply backfires. Cars may even be a good thing, "synonymous for many with the freedom to decide, at any time, where to go".

The Green Party's strategy paper went on to acknowledge that:

> For women, the car means security on the streets at night and the possibility of combining family and career. For the old and handicapped, it is a synonym for independent movement.

The rethink by the Greens followed a realisation that their crusade against the car was costing votes, alienating the young in particular. Dutch transport policy has also moved away from an anti-motor vehicle stance.

All this is just common sense. Cars have probably done more than any other single invention or discovery in history to expand the freedom and enjoyment of ordinary people day in and day out. Despite anti-motoring policies in Europe, the growth in the number of cars per capita has been much faster there than in the United States. People value the convenience, flexibility and privacy of cars. They are perfectly capable of deciding for themselves how much they want to use cars in relation to other transport options – they do not need to have 'smart growth' or 'light rail' forced down their throats. The reality is that as countries grow richer, patronage of trains and buses typically declines. Passenger transport schemes have generally had small effects at most on commuter transport patterns. New Zealand's experience has been no different.

Will the possibility of global warming change these trends? It seems unlikely. The gulf between the rhetoric and the reality on global warming seems to be widening. Even if the Kyoto Protocol were implemented and all countries met their commitments, the amount of 'saved' warming to 2050 would be negligible – about 0.07 degrees according to one estimate. But the Bush administration in the United States has made it plain that it will not adopt costly restrictive measures such as a carbon tax: the science is too uncertain, warming brings benefits as well as costs, the costs of adjustment may well outweigh those of adaptation and, besides, American voters do not take kindly to fuel tax increases. Governments in other countries are also likely to face a voter backlash unless they are able to make a far better case than they can at present for taking action that will cut household incomes.

There are better strategies from both an economic and environmental point of view than those that have been in vogue in the transport sector over the past 20 years.

As far as tax policy is concerned, it would make more sense to concentrate on lower and more uniform tax rates across the board rather than trying to micromanage economic decisions with special taxes and subsidies. The latter approach is no more likely to be successful than other attempts at central planning. Lower taxes would encourage capital investment in new energy-saving and less-polluting technologies and spur economic growth, which creates both resources and community preferences for higher environmental quality. The greatest environmental advances have been made in the most rapidly growing countries. As a recent paper puts it: "Tax reform is green; 'green' taxes aren't ".

As regards roading, New Zealand is also still stuck in central and local government planning mode. In the early 1990s it was already clear to the New Zealand Business Roundtable that other countries were overtaking New Zealand in the way they ran their roading systems. In a 1993 report we advocated moving away from a system governed by political and bureaucratic decision making to a more user-driven and commercial framework. In essence, this meant treating roading much like other utility industries such as electricity, gas and telecommunications where market-based approaches have greatly improved services and lowered costs.

Government agencies picked up and developed these ideas, but the previous government's efforts to promote a more commercial approach got bogged down in debates with local authorities. Meanwhile, the idea of roading services becoming utilities has gained traction around the world. Several dozen countries have adopted the build-operate-transfer (BOT) model of competitively awarding long-term concessions to private consortia to finance and manage new highways as toll roads. Several countries, including Canada, Italy and Portugal, have gone further, actually selling off existing state toll-road operations. Commercial pricing strategies are in widespread use. In France, for example, several toll roads charge higher prices during weekend hours when Parisians are returning to the city; peaks have been flattened and traffic decongested.

Already about 10 percent of major highways in the United States are operated as toll roads. In California a private company is operating a new expressway that has a pricing mechanism with 16 different express lane rates. If you need to travel promptly in an uncongested lane you are alerted by electronic signs as to the best option and you pay a little extra. If you are on a Sunday cruise you can choose a cheaper lane.

Toronto now has a fully automated toll road using both electronic toll tags and video licence plate imaging, as does the Melbourne CityLink.

Opposition to such developments is becoming less strident. With the new technologies, the inconvenience of stopping at toll booths is disappearing. Rebates of fuel taxes for distances driven on toll roads are reducing the problem of 'double taxation'. Taxes on fuels are becoming problematical as vehicle fuel efficiency improves, forcing moves to direct charging. Tolls are no more 'regressive' than fuel taxes – the evidence indicates that the amount of driving increases greatly with the level of income. Tolls should be a permanent, ongoing funding source for maintaining and rebuilding roads, just like electricity and telecommunications bills – not removed when the initial investment is recovered. Few people object to direct pricing in other utilities. With proper economic pricing and commercialisation there is a more level playing field between roads and public passenger transport, and the case for public transport subsidies – which has always been a weak one – disappears. Several US environmental groups have become advocates of pricing and even of road utilities.

In contrast to this ferment of innovative developments, the stalemate on roading reform in New Zealand is lamentable. Almost halfway through the present government's term there are few signs of progress. There is talk of forming 'clusters' of local authorities to facilitate planning, but commercial models and economic pricing seem to be off the agenda. Meanwhile, congestion in Auckland worsens each year, and demand and investment patterns remain distorted by uneconomic pricing.

There is little hope of improvement, I suggest, until the utility model for roading is adopted. Procrastination and the blocking power of entrenched interests are endemic with political decision making. Commercial decision making is not perfect, but uneconomic decisions are not systematically made and mistakes are corrected more quickly. The most speculative of the dotcom companies crashed and burned in the space of a couple of years in the United States, whereas it has taken that country 40 years to recognise and start correcting the problems of its welfare system – and New Zealand has hardly even embarked on that task. That is the story of politics. Reforms to roading management, combined with similar moves to convert water and sewerage services into commercial utilities (or franchise them), would permit a major and badly needed reshaping of local government – roading and water supply are the main activities of many councils. New Zealand could do with far less local government. For this reason, of course, political resistance from the sector will have to be overcome by any government that is serious about the problems.

Another obstacle in the local government sector that will have to be overcome, if there is to be progress on roading, is the hopelessly cumbersome procedures of the Resource Management Act 1991 (RMA). As Transit New Zealand stated in its recent annual report:

> … it is frustrating to watch projects, often those which have strong local community support, become bogged down in prolonged consultation, and numerous hearings and appeals. Without such delays, the planning and building of roading projects still takes years to achieve. With them, the benefits to road users can be substantially deferred. As well, the associated expense in participating in these processes chews through

> money that would be better invested in the roading network and safety initiatives.

There is mounting evidence that the RMA has become a major obstacle to economic growth and needs a total overhaul.

What is the role of the Automobile Association (AA) in all this? In my view it has made some excellent contributions, such as last year's 'call for action' based on a survey showing that 83 percent of Aucklanders want the region's long-planned transport network completed. I hope the AA will continue its advocacy role, and I make the following suggestions.

First, maintain a broad approach to roading reform. Do not just simplify the message to 'build more roads', or 'don't divert petrol tax to the consolidated fund' (even though it is true that only the GST rate should apply over and above the charge for road use). It is sheer folly simply to go on constructing roads to meet demand that is not properly priced. Similarly, just spending more money on roads will achieve little if the present dysfunctional political decision-making system is left in place – in 10 years' time there will be another catalogue of bad and delayed decisions. The only real solution is to move roading to a utility model with a variety of direct relationships between users and operators across the country. There is no long-term role for Transfund: we should cut out the people in the middle.

Secondly, there is no need to take an anti-public passenger transport stance, but there is no need to pander to the public transport lobby either. In a neutral environment roads and passenger transport should be allowed to compete without subsidy. Public transport can only make a modest contribution to transport solutions in the major centres, and little or none in the smaller ones. Councils like the Auckland City Council still have their heads in the sand in this regard. The big issue is roading: the AA should insist that politicians concentrate on the dog and not allow the tail to wag it.

Thirdly, take a principled stance on the global warming issue. The scientific evidence is still strongly contested, and it would be madness for New Zealand to impose economic costs on itself if the United States – where average incomes are now twice those of New Zealand – chooses not to do so. If action is ultimately justified, it should apply even-handedly to industrial, transport and agricultural emissions. Sectors should not argue for special treatment; politicians would be only too likely to pick them off one at a time. A more efficient roading system with less congestion would do far more to lower emissions than many of the measures the government is talking about.

Finally, I suggest the AA should renew its 'call for action' on roading reform. There have been years of inaction, and the issue is still drifting. On many measures of economic performance New Zealand has been losing ground against more successful countries after a period of catch-up in the early-to-mid-1990s, and it will continue to do so if the weaknesses of major sectors like roading are left unaddressed. My chairman, Ralph Norris, expressed the hope that the 'Case for Roads' conference in Auckland earlier this month would be a giant wake-up call to those responsible for decisions about roads in New Zealand. I hope the AA will join us, and other business, organisations in making that call with new urgency.

'THE CASE FOR ROADS' CONFERENCE

REMOVING LEAD FROM THE SADDLEBAGS: CHALLENGES FOR NEW ZEALAND IN A GLOBAL SETTING

RALPH NORRIS
CHAIRMAN
NEW ZEALAND BUSINESS ROUNDTABLE

AUCKLAND
8 MARCH 2001

REMOVING LEAD FROM THE SADDLEBAGS: CHALLENGES FOR NEW ZEALAND IN A GLOBAL SETTING

Sketching out the backdrop to this discussion on roads is pretty straightforward.

New Zealanders want higher living standards. To achieve them, we need a growing economy. Growth requires us to use scarce economic resources efficiently, and to compete successfully in the world economy. To do so, we cannot afford to have lead in our saddlebags. Among other things, we need efficient infrastructure. As far as transport infrastructure is concerned, by far the greatest handicap is roading – for New Zealand and for Auckland in particular. The title of the last government's consultation document *Better Transport Better Roads* sums up in a nutshell the priority that must be given to roading reform if we want the benefits of a better transport system for economic growth and higher incomes.

That outline of my argument should not be controversial, at least not among the community at large. A 1999 Massey University survey of New Zealanders' attitudes and values about politics and government found support for economic growth came out far ahead of other goals.

Some people make the point that there is more to life than material well-being; they say things like 'money isn't everything'. That is perfectly true, although such sentiments tend to come from relatively well-off people rather than those less well off. If we are concerned about poverty, we have to be concerned about economic and employment growth. Redistribution cannot go far towards solving problems of poverty and, indeed, welfare can easily make them worse. I will believe most people are unconcerned about their incomes the day unions stop making wage claims.

And New Zealanders have good reason to be concerned about the state of their incomes. On average, incomes here have grown far more slowly than in other countries for many decades. New Zealand's per capita economic growth rate in the period 1900–97 – practically the whole of the last century – was only 41 percent of the developed world average. Australia's was only 58 percent. Growth effects compound: a hundred years ago average incomes in New Zealand were around 50 percent higher than the developed country average; today they are some 40 percent below that average.

It does not have to be like this. We know that countries can go from the third world to the first world in a generation – Singapore, Hong Kong, Taiwan and Korea have done just that. New Zealand was making up ground in the 1990s – the 1991–97 expansion was the longest and strongest since the 1960s. Since then, among other things, policy inertia, modifications and reversals, and a general failure to press on with economic reform, have taken their toll. On the government's own figures the economy looks likely to grow by only 2 to 3 percent a year in the years ahead. This is a recipe for losing further ground.

The debilitating consequences of such an outlook in today's more open and mobile world should not be underestimated. Average per capita incomes in Australia are now some 40 percent higher than those in New Zealand – and yet Australia is struggling to hold many of its most able and enterprising people. Countries can reverse a 'brain drain': Ireland showed that after its economic reforms of the late 1980s, as did New Zealand in the early 1990s. But equally, the problem can become endemic: Tasmania has been losing people for years, and official projections suggest its population could halve by 2050. I suggest not many New Zealanders want the country to become an economic theme park.

To avoid that outcome, much will have to change. There are no 'circuit breakers' or 'silver bullets' in the economic management business: a country has to get many things right, and keep on making improvements. Spurts of activity followed by siestas will not work. We know that in our businesses; it is no different in our national affairs.

Internationally, there is no longer much debate about the requirements for growth. The countries that are getting ahead are striving to make themselves attractive for business and investment. They are embracing globalisation, reducing regulation and compliance costs, upholding property rights and the rule of law, focusing on core government activities including infrastructure, reducing taxes, avoiding inflation, upgrading education, removing obstacles to employment and reducing welfare dependency. Overall, this is an agenda for smaller, better government, and for greater economic freedom and individual responsibility.

New Zealand needs to do all those things. It must aim to do them better than other countries to offset its disadvantages of size and location. In addition, if we want prosperity we must value and reward excellence and achievement while holding to our traditions of fair opportunities for all. A loser-oriented and profit-deriding society will attract losers and repel winners.

A key issue for a small, remote economy is transport and communications costs. New Zealand can only prosper through specialisation and trade. Containerisation and other technological changes in industries like sea and air transport and telecommunications, as well as policy reforms, have dramatically cut costs and had the effect of bringing New Zealand closer to world markets. Waterfront employment reforms have greatly increased the viability of industries like forestry, which is why the hard-won gains must not be lost. But the costs and quality of internal transport services are equally important for international competitiveness. We have made much progress with domestic transport services such as air travel, rail, trucking, taxis and coastal shipping. The standout exception is roading.

As far back as 1993 the New Zealand Business Roundtable released a major study on options for roading reform in New Zealand. Its ideas were quickly picked up and developed by people in government agencies. Regrettably, as in many other areas that are crying out for reform – the water industry is another example – they have subsequently gone nowhere. A combination of a lack of political leadership at central and local government level, parochialism and vested interests have frustrated any real progress.

The basic problem with roading management, as diagnosed in our study, is that it operates on a Soviet-style model – just like so many other things in New Zealand 15 years ago. Roading is determined by central and local government planning – it is not driven by consumer demands. Resources are allocated to a large extent by political and bureaucratic processes rather than commercial criteria. Rationing in the form of congestion, rather than pricing, is the norm in key parts of the system. Capital funds are allocated by an arbitrary benefit/cost limit that tells us that something is seriously wrong with either the level of funding or the calculations, or both.

The contrast with telecommunications could not be greater. When the New Zealand Post Office ran the telephone system the main congestion problem in Auckland was telecommunications – making a call in the central business district or getting a simple telephone connection was an exercise in frustration. Today's telecommunications system is market-driven: owned by profit-making firms, using market prices to equate supply and demand, and directing investment to where it is most needed to meet customer demand. The days when the main complaint politicians received was about telephones have long since gone.

Yet the Soviet mentality remains alive and well in roading. A classic example was a statement by the Wellington Regional Council a few years ago. It resolved that:

> … the capacity of the roading system should only be extended to meet the needs of commercial road users and off-peak, rural and recreational travellers, rather than the needs of peak period car commuters.

Commenting on a similar mindset in the United Kingdom, the economics editor of the *Financial Times*, Martin Wolf, recently wrote:

> Imagine that customers were deterred from visiting a supermarket by the length of its check-out queues. It would be astounding if the company's board refused to expand capacity on the grounds that this, too, would ultimately become crowded.
>
> Yet the same people assert that additional road space should not be provided because it will become congested … The rational approach is to manage congestion through prices, rather than queues, and to invest in additional space, provided users are prepared to cover marginal costs, including the social and environmental costs.

Auckland's congestion problem is a national disgrace; I cannot understand why it has not become a huge political issue. Cities with a population of a million or more around the world do not typically snarl up the way Auckland does. I submit there are three basic elements of a solution to Auckland's problems:

- First, build more road capacity. Transit New Zealand's 10-year plan is only an economy version of what was envisaged in the 1960s, but it should be implemented urgently without planning delays.

- Secondly, face users with the true costs of services by introducing proper economic pricing. This means, in particular, peak and off-peak charges for roads, but it is equally foolish to under-price or give special privileges to public transport services through subsidies and regulation.

- Thirdly, put the management and operation of roads (not the planning function) on a similar basis to other utilities like telecommunications, and extricate it from political control. Running the system on a commercial basis, subject to necessary regulation, is consistent with public ownership, at least in the first instance, but ideology should not prevent examination of private sector options. Already companies owning around $3.4 billion of tollroads are now listed on the Australian Stock Exchange, and there are many examples of public and private sector partnerships in roading around the world.

I want to stress the importance of all three elements of this package for any fundamental solutions to Auckland's problems – and they apply to the rest of the country as well. This conference would do no one a service if it just argued for spending more money on roads. It makes no sense to go on building roads endlessly to meet peak demand at current prices: the economic distortions and waste would be as great as those associated with earlier follies such as livestock subsidies. And we cannot hope for timely and efficient decision making while roads remain under direct political control: the present state of affairs is clear-cut evidence of that. The problem is not the people but the dysfunctional system.

As far as Auckland is concerned, I would also add that it would make little sense to remove road management from existing authorities only to put it in the hands of one large regional organisation. There are problems of monopoly in roading just as there are in some other utilities, and we should not compound them by eliminating the scope for competition that does exist. At the very least, having two or more operators in the region would encourage useful rivalry and experimentation, and comparisons of best practice.

Other sessions at this conference will look at alternatives to roading, such as so-called 'smart growth' planning strategies and public transport. The problem with these is that they are economically costly, they restrict people's freedom, and, as a serious solution to the problem, they do not work. Passenger transport has a role to play, and it should be allowed to find that role without public ownership or subsidies in competition with other properly priced transport modes. But when it can, at most, account for somewhere between 5 and 10 percent of peak demand for transport in Auckland, it is time politicians got things in proportion and devoted most of their efforts to the services that 90 percent or more of the population want to use.

A few years ago New Zealand was a world leader in its thinking about roading, but it is now lagging behind much of the world in putting it into place. We have talked the talk but not walked the walk. We cannot hope to match other countries' improvements in economic performance if we do not take advantage of new approaches to road management, pricing, investment and technology. Bottlenecks in areas like housing, schools, water supplies and roading put strain on the economy, and the export industries in particular, when New Zealand was growing rapidly in the mid-1990s. These problems have not been solved; they remain a constraint on faster growth.

Roading is a big chunk of the economy. People in some parts of Auckland are about to receive a share of a dividend of over $150 million from Vector. The economic costs of road congestion in Auckland have been estimated to be the thick end of $1 billion annually. The Auckland region as a whole could receive the equivalent of the Vector dividend in the form of lower costs and higher output perhaps six times over, each year, if transport problems were seriously addressed. The benefits would be multiplied nationwide. The stakes are very high. I hope this conference results in a giant wake-up call to those responsible for decisions about roading in New Zealand.

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE NEW ZEALAND SUPERANNUATION BILL

FEBRUARY 2001

NEW ZEALAND SUPERANNUATION BILL

Summary

- The pre-funding proposal is largely an accounting exercise with no direct economic impact on the retirement income problem. As now spelled out, it is essentially a tax-smoothing scheme. At their peak, capital withdrawals would cover no more than 14 percent of the annual cost of New Zealand Superannuation (NZS). Because the level and conditions of access to NZS remain unchanged, the long-term burden NZS imposes on the government's finances and the economy's capability to produce the goods and services needed by people in retirement remain unaltered.

- From a financing point of view, the more logical approach would be to reduce debt further in the period ahead and/or cut taxes rather than establish a massive government-directed investment fund. Any benefits from pre-funding in terms of discipline on other elements of government spending could be largely achieved by publicly reporting future NZS liabilities.

- By promoting the notion that NZS can be maintained in its present form and that the Fund will solve the superannuation problem, the government is undermining past attempts to highlight the gravity of demographic trends and to encourage people to assume personal responsibility for their income in retirement. A significant change in behaviour will not occur if the form of NZS remains unaltered. The key requirement in any sound approach to retirement income is to extend the process of reducing the generosity of NZS and making access to it more restrictive for the next generation of retirees, while protecting those currently in retirement.

- It follows that the pre-funding proposal contained in the New Zealand Superannuation Bill (the Bill) is a distraction from the central issues in retirement income policy that are the performance of the economy, which underpins the living standards of the elderly and is undermined by high spending and tax burdens, and the form of the public safety net. The debate should be refocused on these issues through a process designed to facilitate public and inter-party support for a stable long-term policy.

1 Overview

1.1 This submission is made by the New Zealand Business Roundtable (NZBR) 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.

1.2 The NZBR has taken a close interest in superannuation issues and has contributed to all government reviews undertaken since the mid 1980s. Government policy on superannuation is a significant issue for superannuitants, people of working age and the wider community. New Zealand Superannuation is the government's largest spending programme.

1.3 Policy on superannuation has generally been moving in the right direction. The age of eligibility is being raised to 65 years and the level of NZS has been reduced relative to wages. These measures have produced substantial fiscal savings without imposing undue hardship. The main decision that we regard as unsound was the abolition of the surcharge from April 1998. The proposal to lift the minimum level of NZS to 65 percent of the net weekly ordinary time wage, which is contained in clause 16 of the Bill, is also a step in the wrong direction.

1.4 New Zealand Superannuation remains a serious problem because it transfers an excessive level of income to retirees, particularly to those who are well off by any standard. New Zealand Superannuation thereby crowds out consumption opportunities for people of working age. It unduly discourages private provision for income in retirement and participation in the workforce by people aged over 65 years. New Zealand Superannuation also imposes large deadweight costs on the community because marginal tax rates are higher than otherwise. The transfer of income from people on low or modest incomes to people who are well off is inequitable.

1.5 The key requirement in any sound approach to retirement income is to extend the process of reducing the generosity of NZS and making access to it more restrictive for the next generation of retirees, while protecting those currently in retirement. The government's objective of providing more stable and certain superannuation arrangements cannot be achieved unless these matters are addressed. The OECD, the IMF and other expert commentators have continued to advise that, by international standards, NZS is a generous scheme.

1.6 The pre-funding proposal contained in Part 2 of the Bill is largely an accounting exercise with no direct economic impact on the retirement income problem. The long-term burden that NZS imposes on the government's finances and the economy's capability to produce the goods and services needed by people in retirement would be unaltered by the establishment of the Fund.[1]

1.7 The cost of NZS is determined by the level of superannuation payable and related eligibility rules. They would not change (aside from the increase in the minimum level of NZS) and, thus, the ratio of NZS to GDP would be largely unaffected. This ratio is forecast by the Treasury to rise from about 4 percent presently to a peak of over 9 percent. What is more, NZS is forecast to be equal to 9 percent of GDP in every year from around 2050 to 2100 when the Treasury forecasts of December 2000 end.

1.8 The main feature of the proposal is the provision for annual capital transfers to the Fund up to around 2020. The transfers would be invested in assets. In the absence of tax increases or reductions in operating spending, there would be less finance than otherwise for capital spending and debt repayment. Thus lower capital spending, higher net debt, or both would be required to make capital contributions to the Fund. Similarly, the withdrawal of accumulated capital from the Fund after 2020 would reduce net borrowing, fund capital spending, or both. The Treasury's forecasts show that capital withdrawals would, at best, be equivalent to only 14 percent of the annual cost of NZS (net of tax). This is a small amount and is probably within the margin of error for projections so far into the future.

1.9 The total amount of NZS paid to retirees each year would continue to be charged against the government's operating revenue. Even when the Fund is

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1 Second and subsequent round effects may affect this and other conclusions noted.

being drawn down, the cost of NZS – gross of any withdrawals from the Fund – would be charged to operating revenue. Thus the claim on government operating revenue would be unchanged. This treatment is required to record properly the cost of NZS in the Crown's operating account. It means, however, that the operating balance would not be affected directly by the establishment of the Fund. The operating balance would be reduced by higher debt servicing costs than otherwise but such costs would be offset by the net earnings on the Fund's assets.

1.10 From a financing point of view, the more logical approach would be to reduce debt further in the period ahead and/or cut taxes rather than establish a massive government-directed investment fund. Any benefits from partial pre-funding in terms of discipline on other elements of government spending could be largely achieved by publicly reporting future NZS liabilities.

1.11 The record of successive governments in managing commercial activities provides little confidence that the Fund would be invested in the best interests of the wider community. While the Bill contains some measures aimed at reducing the risk from political pressures, they are unavoidably partial.

1.12 The guardians face weak incentives to act in the wider community interest. Current and future retirees have little direct interest in the performance of the Fund because their income in retirement is set independently of the return on the Fund. It is underwritten by the government's ability to tax.

1.13 Superannuation policy will remain contentious and unduly uncertain until a sound policy that is fair both to retirees and to people of working age is implemented with the support of the main political parties and the public. The partial pre-funding of NZS, as proposed in the Bill, would not contribute to a sound and fair policy. The detailed design of the scheme has not been explained to the public, and the merits of the proposals have not been debated widely.

1.14 There would be few, if any, public benefits from transferring statutory entitlements to NZS from the existing legislation to the proposed legislation but sizeable costs in terms of parliamentary time, publicity, printing and compliance. Work and Income New Zealand will continue to administer NZS, the machinery provisions of the Social Security Act 1964 will still apply and supplementary assistance will continue to be available under the 1964 Social Security Act.

1.15 The NZBR submits that the Bill should not be enacted. Instead the government should establish a process designed to facilitate inter-party agreement that commands support from the public on superannuation provision to apply to future retirees, and it should focus on setting in place a growth strategy that will raise the living standards of the community, including future retirees.

1.16 The balance of this submission is presented in three sections. The next section (section 2) presents an analysis of the proposal to establish the Fund. Alternative directions for retirement income policy are discussed in section 3. Our conclusions are presented in section 4.

2 An analysis of the Fund

2.1 The level of government spending and taxes would essentially be unaltered by the proposals contained in the Bill. The annual capital contribution to the Fund is to be made 'below the line'. It is discretionary. Taxes are not to be raised or current spending cut to build up the Fund. The government has indicated, for example, that it does not propose to cut spending this parliamentary term to increase surpluses. Any future reductions in spending are vague and uncertain. The government increased the long-term target for expenses as a ratio of GDP by 17 percent from 30 percent to 35 percent in the March 2000 Budget Policy Statement.

2.2 A move to a fully funded scheme requires the working age population to pay twice through higher taxes or through lower current spending while taxes are held constant. This would require the government's operating balance to be higher than otherwise. A move to fully fund NZS is not proposed because "it would require a massive reallocation of government expenditure and would be unrealistic".[2] A move to a partially funded scheme requires the working age population to contribute more than the cost of NZS payable to retirees and also requires the operating surplus to be higher than otherwise. There is nothing in the Bill or the official papers that commits the government to achieving a higher operating surplus.

2.3 The level of NZS is to be set independently of the amount of the Fund and its rate of return. According to Dr Cullen, "Labour wants to ensure that … the future retired … share the same relative standard of living as the present retired".[3] What is more, the Fund is eventually to be reduced to a zero balance leaving present arrangements intact, despite the Treasury's prediction that the ratio of NZS to GDP would still be around the peak level of 9 percent as the Fund is run down. Thus the Fund will have no direct impact on the level of NZS in the future.

2.4 The government correctly acknowledges that the "economic implications of pre-funding are not as significant as the economic implications of the retirement income policies being financed – that is, NZS rates and the tax policies accompanying them".[4] The government does not propose to change the eligibility rules for NZS or the level of NZS, aside from increasing the wage floor. Part 1 of the Bill generally provides for existing arrangements to continue but under new legislation.

2.5 The proposed Fund would not achieve its stated public policy goal. The government's Regulatory Impact Statement states that "The public policy objective of pre-funding is to address the future increase in NZS costs".[5] The proposal in the Bill would not do this. The annual ratio of NZS to GDP would be unchanged. Similarly, the ratio of NZS to government operating revenue would be unaltered.

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2 Cullen, Michael (2000a), *Pre-funding New Zealand Superannuation: Funding Arrangements*, report to the Cabinet Policy Committee, Office of Hon Dr Michael Cullen, 6 September, p 1.

3 Cullen, Michael (1999), 'Littlewood Report Rebutted', Labour Party press release, 17 November.

4 Cullen, Michael (2000a), *op cit*, p 4.

5 Cullen, Michael (2000b), Regulatory Impact Statement, report to Cabinet Policy Committee, Office of Hon Dr Michael Cullen, 6 September, p 1.

2.6 For the same reasons, the proposal in the Bill would not alleviate the burden of NZS on future workers despite the following claim by the minister of finance:

> Although there are currently about 6 working age people per superannuitant, by 2050 there would be only about 2. It is both unfair and unrealistic to expect that relatively small working age population to have to meet those future costs.

The reality is that the unfair situation described by the minister is largely unchanged by the Bill. Future workers would be required to produce most of the goods and services consumed by retirees and they would largely bear the cost of providing NZS to retirees.

2.7 Clause 45 of the Bill proposes that the annual cost of NZS (net of income tax) be transferred to the Fund for the purposes of paying entitlements to superannuitants. This leaves the substance of present arrangements unaltered.

2.8 The Bill also provides for transfers to the Fund by way of capital contributions (clauses 42, 43 and 44). As a consequence, funds available for capital spending and debt repayment would be lower than otherwise. Crown liabilities (excluding the Fund) would be higher and/or assets (other than Fund assets) would be lower than otherwise. Thus, the transfer of capital contributions to the Fund when the Crown holds debt is equivalent to borrowing to invest in the Fund's assets. If governments could prudently accommodate a future increase in spending by borrowing and investing in risky assets, they would have implemented such a strategy long ago. There is no reason to single out NZS for financing in this way; if the method were valid it would be applied to other government programmes.

2.9 The point that the proposal involves government borrowing to invest in assets could be demonstrated by preparing Crown accounts in which the Fund is consolidated with other government entities on a line-by-line basis.[6] Such accounts would show that the Crown's operating surplus is little changed but net debt and financial assets are increased massively as the Fund is built up. The Committee could ask the Treasury to forecast such accounts, with and without the Fund, annually for the life of the Fund.

2.10 The pre-funding proposal would not raise the productivity of the labour force or increase the ratio of workers to retirees (for instance, by encouraging people over 65 years of age to remain in the workforce, or through immigration). There is, therefore, no reason to believe that consumption in the future would be increased. The material welfare of future retirees depends on the level of goods and services available for consumption during their retirement. Thus they are ultimately dependent on a productive economy generating the necessary flow of goods and services to meet their needs. People cannot eat dollar notes. As Michael Joseph Savage correctly observed, "It does not matter how much we try to manipulate the money system we cannot give the people any more than they are able to produce".[7]

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6 Crown agencies and SOEs are not presently consolidated on a line-by-line basis. It is intended, however, to move to this basis shortly.

7 Savage, Michael, debate on introduction of the Social Security Bill, 1938.

2.11 The minister of finance has argued that an increase in productivity does not help deal with the problem of an aging population because wages will increase as productivity increases and NZS will rise with them in line with the wage band.[8] Thus, in his view, increasing the size of the economic cake does not help address the superannuation problem. This view, however, is mistaken. First, increases in capital productivity and innovations raise total factor productivity and may enable GDP to increase without necessarily increasing wages and NZS. Secondly, people not previously available for employment and the unemployed may be prepared to take up employment without requiring an increase in real wages. This is one reason why the level of employment and the economy expanded substantially in the 1990s without a large increase in real wages. Thirdly, the link between real wages and NZS could be changed. It is certain to change if the number of workers for each superannuitant falls to two around 2050 as the minister predicts.[9, 10]

2.12 Aggregate savings would not be increased by the creation of the Fund. The government does not intend to increase its savings. This would require higher taxes and/or lower government spending on consumption goods and services. The government has given no indication that it intends to raise taxes further or to cut such spending in response to the increased burden of NZS. While the proposal to make capital contributions to the Fund may put pressure on capital spending, such as the construction of school and health care facilities, any reduction in capital spending would affect the allocation of savings rather than their level. There is no reason why private households would increase their savings. On the contrary, to the extent that the government convinces people that pre-funding would ease the problem of funding NZS in the future, private savings could well fall.

2.13 Investing in equities does not increase the risk-adjusted return on assets. The Crown would simply assume more financial risk than otherwise. Borrowing to invest in equities and other high-risk investments further accentuates the financial risk involved. If the government assumes more financial risk, other investors would carry less risk. The level of risk associated with the underlying real assets is unaffected by financing arrangements. Such arrangements merely redistribute the risk among different classes of investors.

2.14 Investment in offshore equities is unlikely to increase the level of imports that can be sustained in the future. If there is an increase in capital outflows while the Fund is being built up, there must (other things being equal) be an offsetting capital inflow or a change in the level of the current account balance (higher exports and/or lower imports). In these circumstances a change in the level of

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8 Cullen, Michael (2000c),'Denying Superannuation Problem Helps No One', *New Zealand Herald*, 4 April.

9 Cullen, Michael (2000d), '1st Reading NZ Superannuation Bill', Office of Hon Dr Michael Cullen, 13 December.

10 The present living alone rate of NZS is equal to about 44 percent of the average wage before tax. Thus, a ratio of, say, six workers for every superannuitant living alone would require a tax of about 7.3 percent just to fund NZS. At a ratio of two workers for every superannuitant, the tax would need to increase by 300 percent to 22 percent. This tax rate is around the present average rate of income tax. Additional tax would be required to fund other government services. It is implausible to argue that such a massive increase in taxes could be imposed on workers to maintain the relative income standards of a growing ratio of superannuitants to workers. Adjustments to the level of NZS, other government services and tax rates are all likely.

the current account is unlikely given that the fiscal position and private savings would not be changed. Higher government borrowing than otherwise and changes in private sector capital flows are likely to match the outflow of capital to acquire offshore investments. These processes would reverse as the Fund is drawn down.

2.15 The record of successive governments in managing commercial operations provides little confidence that the Fund would be invested in the best interests of the wider community. While the Bill contains some measures aimed at reducing the risk from political pressures, they are unavoidably partial. The legislation, for example, can be changed by a majority of parliament. The requirement in clause 73 to consult other political parties could be repealed if it proves to be inconvenient to a future government with sufficient votes. Compliant guardians can be appointed. The minister of finance has wide power to dismiss guardians (schedule 3, clause 10). The proposed legislation has already been altered to accommodate the Green Party's view that the Fund should not be invested in activities that are judged to be unethical.

2.16 A fundamental problem is that the guardians face weak incentives to act in the wider community interest. Current and future retirees have little direct interest in the performance of the Fund because the level of NZS is set independently of the Fund's financial performance. New Zealand Superannuation is underwritten by the government's ability to tax. The Bill also exempts the guardians from personal liability provided they act in good faith, and the Fund is to indemnify the guardians for the costs of certain civil actions (schedule 3, clause 8). Those provisions go further than the indemnity that a company is permitted to provide to a director under section 162 of the Companies Act 1993.

2.17 The Fund is projected by the Treasury to rise to 49 percent of GDP or about $50 billion in today's terms. The investment decisions of the guardians have the potential to distort the pattern of investment. Their preferences may, for example, be vastly different from that of other investors. The experiences of the BNZ, DFC and ACC illustrate the potential risk to taxpayers when government agencies that are subject to weak governance arrangements make poor decisions.

2.18 The proposal also raises the following issues:

- The Bill proposes that capital contributions cannot be withdrawn before 2020 (clause 47). However, the investment of the Fund in government bonds would have the same economic effect as a capital withdrawal. This highlights the illusory nature of the Fund.

- The minister of finance's statement that the Fund "will finally give superannuitants some certainty about what the government will be able to provide for them" is groundless.[11] The government's stance has the potential to undermine the thrust of education programmes encouraging people to recognise that NZS is a problem and exhorting them to save for their retirement.

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11 Cullen, Michael (2000d), *op cit*.

- The idea that the Fund could be modified to incorporate individual accounts lacks logic. Suppose the proposed transfers for annual expenses and capital contributions are allocated to individual accounts within the Fund with no other changes in the method of financing or entitlements. In this case the balance in an individual's account would have no effect on the level of NZS payable and would thus be irrelevant to the account holder. The level of capital contributions allocated to each individual's account would be arbitrarily determined because it would be unrelated to the level of tax paid by each account holder. Practical issues about who should be recognised as an account holder would arise (for example, citizens, residents, immigrants, children and refugees). The balance in accounts is unlikely to be permitted to be withdrawn by account holders (or their estates) should they emigrate or die before reaching 65 years of age because this would diminish the Fund. If funds could be withdrawn, the proceeds of government debt would, at the margin, be distributed to account holders and the government would be left with a liability that was not matched by a related asset. If, however, income-related contributions are credited to individual accounts and the level of such accounts affects entitlements, the proposal would be similar to the compulsory retirement savings scheme that was massively defeated in the 1997 referendum.

3 Alternative directions for retirement income policy

3.1 Over the past 16 years New Zealand has been moving toward a sounder policy on superannuation. There is now broader acceptance that, for the majority of people, retirement income should be a personal responsibility, not a taxpayer responsibility. There is greater understanding that living standards in retirement are ultimately dependent on the productivity of the economy, not financial arrangements. The cost of NZS has been reduced by increasing the age of eligibility, lowering its level relative to wages until the recent increase, and – until the decision to scrap the superannuation surcharge – by targeting.

3.2 The 1997 argument over the Retirement Savings Scheme was not about public versus private provision; the underlying premise was that private provision should increasingly be the norm and the issue was whether it should be compulsory or voluntary. That argument has been settled, at least for the foreseeable future. The result of the referendum should give confidence that, given proper information, debate and leadership, the community is capable of changing its views and coming to sound conclusions.

3.3 There is now no political constituency for tax concessions for savings, which essentially amount to bribing people with their own money. The minister of finance's TET (taxed, exempt, taxed) proposal (whereby the earnings of superannuation funds would be exempt from tax but benefits paid would be taxed) is unlikely to proceed because, among other things, it is very costly to introduce. Selective concessions, as opposed to general reductions in spending and taxation, are not the way to go.

3.4 Because some people will not be able to provide for their own retirement, other forms of income security are required. Arguably family and voluntary sources should be the means of first resort, but the state needs to provide an ultimate safety net.

3.5 The long-run tradition in New Zealand has been to view policies for income security in retirement as part of the general safety net. Unlike many other countries, benefits have always been flat rate rather than income-related and they have been funded from general taxation rather than compulsory contributions based on income. New Zealand's initial Old Age Pension of 1898 provided benefits at a very modest level to claimants who were 65 or more years of age – a high qualifying age relative to life expectancy at that time. Moreover, the benefit was subject to strict income and assets tests, and to tests of reputable behaviour – there were strong incentives for personal responsibility. Retirement income policies remained generally sound and stable until the electoral bidding wars of the 1970s.[12]

3.6 Viewed in safety net terms it is hard to see how the government's welfare responsibility for people in old age differs from its role in respect of those facing other lifetime contingencies, namely to protect people from hardship.

3.7 Families are normally expected to be responsible for providing for their own incomes, and the role of the government is limited to providing support to those without other means in the case of events such as sickness, invalidity or unemployment. The only difference from other benefits is that in the case of old age there is no explicit test of incapacity to earn an income once a certain qualifying age is reached.

3.8 There are no sound efficiency or equity grounds for a universal benefit, and the fiscal costs and deadweight losses associated with such a scheme are large. The Periodic Report Group signalled its support for some form of targeting in its 1997 assessment. It is hard to argue that a retired millionaire's income should be supplemented by taxes on low-income workers who are struggling to support their families. In the case of the next income group, the broad category of middle-income earners, all that is happening with a non-targeted benefit is that the government is taxing one group of people only to return the money to people in a similar category, with all the compliance, administration and deadweight costs associated with such 'churning'. It is only the category of low-income earners and people without resources who should be the object of public policy, on either efficiency or equity grounds, through targeted assistance.

3.9 The only significant advantage of a universal benefit over a targeted benefit is that, because it is not abated against other income, retirees do not face a 'penalty' for saving. This advantage, however, is more than offset by the higher taxes and therefore general savings disincentives for all taxpayers associated with having to fund a costly universal scheme.

3.10 The arguments against a straightforward targeted benefit do not stand up. It sits logically with the rest of the welfare system that is needs-based; it is the option most consistent with an ethos of individual responsibility; and because it involves the lowest fiscal cost it is the option most conducive to economic growth. It is the approach that is applied to people over the age of 65 who do not qualify for NZS, for instance, because they cannot satisfy the residency requirement. It also happens to be the option historically favoured in New

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12 For further elaboration, see Thomson, David (1998), *A World Without Welfare: New Zealand's Colonial Experiment*, Auckland University Press with Bridget Williams Books, Auckland.

Zealand and it is accepted as the appropriate form of public provision, without significant political controversy, by Australia. The Australian scheme includes an assets test that is a logical element of any targeting regime, as experience with the surcharge showed.

3.11 New Zealand Superannuation remains a generous benefit relative to policies in other countries. A high level of benefit discourages private provision. It is hard to see the grounds for a level of benefit higher than the invalid's benefit, which is intended to support a person on a long-term basis. Consistent with a safety net approach, the 1988 Royal Commission on Social Policy proposed that NZS should be set at the (lower) level of the invalid's and other long-term benefits.

3.12 A reduction in benefits for people in or near retirement who are fully dependent on them is not necessary, with the important proviso that New Zealand does not lapse into stagnation or economic crisis again. In that case all bets would be off. On the other hand, it is hard to see why future cohorts of retirees should not be required to plan on the basis that public provision will be no more generous than the general safety net.

3.13 The increase from 60 to 65 in the qualifying age for NZS is proceeding smoothly (assisted by some transitional measures). It has been the main reason for the fall in the fiscal costs of NZS as a proportion of GDP. It has also encouraged workforce participation by those over 60 years of age, a positive factor for economic growth and arguably beneficial in social terms.

3.14 With better health and rising life expectancy there is scope to extend the working life of most people who would otherwise be dependent on NZS beyond 65. People who are in poor health or are otherwise unable to work would automatically qualify for assistance under the general safety net. Over time an increase in the qualifying age in the range of 68–72 is suggested. People would, of course, be free to retire earlier on their own savings.

3.15 The only hope of achieving consensus and stability is to build retirement income policies on a sound conceptual foundation. Policies in the recent past lacked such a foundation and proved unsustainable. Poorly conceived ideas like the compulsory retirement savings scheme could not withstand intense scrutiny and debate, and the pre-funding proposal will sooner or later suffer the same fate.

3.16 Policies to promote economic growth must be brought back to centre stage. New Zealand badly needs a set of policies more conducive to economic growth and labour force participation than at present. Microeconomic reforms aimed at improving the productivity of both labour and capital are likely to be more effective in raising the rate of growth than policies aimed at lifting domestic savings.[13]

3.17 In respect of private provision, the focus should be on ways to reduce policy-induced impediments to greater private savings, especially through lower taxes to give people more scope to save from higher after-tax income. In respect of public provision, there is a good prospect of achieving a public consensus around the idea of a public safety net just as there is solid public support for a

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13 See Makin, Tony (1999/2000), 'Prioritising Policies for Prosperity', *Policy*, Summer, p 19.

state role of last resort in other welfare settings. Most people are happy to help people who need help, but are not keen on seeing their taxes going to those who do not. Equity and efficiency arguments for other approaches, such as those involving universal payments, are weak and stand little chance of being politically sustainable over the long run.

4 Conclusion

4.1 Policy on superannuation has generally been moving in the right direction. New Zealand Superannuation remains a serious problem, however, because it transfers an excessive level of income to retirees, particularly to those who are very well off by any standards.

4.2 There are no reasons why further moves towards a more limited safety net should not be feasible over the next few years. It is hard to argue for more generous public provision for those without resources in their older age than for other long-term welfare beneficiaries, and against a higher eligibility age as life expectancies increase.

4.3 The pre-funding proposal contained in the Bill is largely an accounting exercise with no direct economic impact on the retirement income problem. The long-term burden NZS imposes on the government's finances and the economy's capability to produce the goods and services needed by people in retirement would be unaltered by the establishment of the Fund. The cost of NZS is determined by the level of superannuation payable and eligibility rules. They would not change (aside from the increase in the minimum level of NZS) and thus the ratio of NZS to GDP would be unaffected.

4.4 From a financing point of view, the more logical approach would be to reduce debt further in the period ahead and/or cut taxes rather than establish a massive government-directed investment Fund.

4.5 The record of successive governments in managing commercial activities provides little confidence that the Fund would be invested in the best interests of the wider community. The guardians face weak incentives to act in the wider community interest.

4.6 Superannuation policy will remain contentious and unduly uncertain until a sound policy that is fair both to retirees and to people of working age is implemented with the support of the main political parties and the public.

4.7 The pre-funding scheme contained in the Bill is a distraction that should be put to one side so that the debate can again focus on the performance of the economy and the public safety net.

4.8 The government should establish a process designed to facilitate inter-party agreement that commands support from the public on superannuation provision to apply to future retirees, and it should focus on putting in place a growth strategy that will raise the living standards of the community, including future retirees.

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE BUDGET POLICY STATEMENT 2001

JANUARY 2001

SUBMISSION ON THE BUDGET POLICY STATEMENT 2001

1 Introduction

1.1 This submission on the Budget Policy Statement 2001 (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 We have made submissions on successive governments' Budget Policy Statements since their inception. This is because we believe that fiscal policy and the disciplines introduced by the Fiscal Responsibility Act 1994 are important for sound economic management and the quality of the communications between the government and the wider community, particularly the investment community.

1.3 We remain concerned that the BPS process is not fully achieving the purposes intended by the Fiscal Responsibility Act 1994. There is little evidence that governments have used the opportunity of submissions and select committee deliberations to test and modify their thinking on budgetary strategies. Under previous governments, fiscal outcomes varied substantially from announced targets yet no significant corrective actions were taken. The select committee and the media have not held governments to account for such failures. Currently the government seems to be unable to engage in open-minded debate about issues such as the case for continuing government ownership of commercial businesses. Rational dialogue is impossible if major issues are simply off the agenda for ideological reasons. Perhaps because of disenchantment with the process, in recent years few submissions have been made on the BPS, which should be one of the most important consultation documents put out by the government each year.

2 Economic growth

2.1 The BPS is important first and foremost because fiscal policy, in particular levels of government expenditure, taxation, borrowing and debt, has a major impact on economic growth. New Zealand's long-term economic growth performance has been poor. Living standards have risen only slowly, and have not kept pace with rises in other countries.

2.2 By the early 1980s, average growth rates had become mediocre and were based on unsustainable borrowing: we estimate that the economy was incapable of delivering more than 1–2 percent annual growth on a sustained basis (and close to zero in per capita terms). Following the reform periods of 1984–88 and 1991–92, annual growth averaged 4 percent up to 1996. Deteriorating policies since then have seen the sustainable growth rate fall back to an average that we would estimate to be 2–3 percent per year. This is a marked improvement on the pre-reform period, and is confirmed by studies showing a major increase in total factor productivity growth following the reforms.[1] The cumulative effect over the average New Zealander's lifetime of this improvement would, if

[1] See especially Erwin Diewert and Denis Lawrence, 'Measuring New Zealand's Productivity', Treasury Working Paper 99/5, 1999.

sustained, be large. However, it falls far short of New Zealand's potential economic performance and means other countries would continue to outstrip us.

2.3 The BPS figures confirm this assessment. The projections up to 2005 show average growth of under 3 percent on an annual basis and do not take account of the recent signs of weakening in the world economy: some forecasters are projecting growth of only 2 percent for New Zealand in the year to March 2002 compared with the BPS figure of 3.7 percent. For the period 2004/05 to 2009/10, the 2000 budget projected average annual growth of only 2.3 percent and 1.5 percent beyond that point. Since the mid-1990s, New Zealand has fallen markedly in international rankings of its relative competitiveness, which are a pointer to future growth performance.

2.4 This outlook suggests that economic performance will not meet the government's goals and calls for a strategy for more rapid economic growth to be implemented to attain them. In effect, the government's own projections are saying that such a strategy is not in place.

2.5 A large body of economic research indicates that policies for economic growth are primarily a matter of getting the institutional and policy environment right. The key ingredients are (a) a legal system that provides for secure property rights and enforcement of contracts; (b) monetary arrangements that achieve price stability; (c) free trade and open markets, subject only to necessary regulation and (d) modest levels of government spending and taxation. The trend to more open economies, lower tax rates, privatisation and deregulation is widespread and continuing. Inevitably, the progress is uneven and the details are unique in each country. But any growth strategy is unlikely to be credible with the international community if it is not in line with mainstream research and thinking and the directions in which successful economies are heading.

3 Size of government and economic growth

A leading researcher on economic growth, James Gwartney of Florida State University, has concluded that for most countries, government spending and taxation levels in the range of 10 to 15 percent of gross domestic product (GDP) are perfectly adequate for the core government functions of providing a range of public goods and a social safety net (including underwriting access to needed social services).[2] Even spending levels of 20 to 25 percent of GDP may not be too damaging if the spending focuses on core functions and is designed to minimise the adverse impact on incentives to earn, save and invest.

Gwartney goes on to say that:

> As government spending moves to 30, 40 and 50 percent of GDP, however, it will undermine both the incentive to earn and the market process. The effects on growth may not be immediately obvious because it takes time for markets to adjust and people to alter their habits and social norms. Modern growth is primarily about gains from trade, discovery and innovation. The adverse effects of

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[2] Government spending was in this range in most countries, including New Zealand, in the early part of last century.

> government on these activities may not be immediately observable … but with time, there will be observable effects on long-term growth.[3]

In response to the question of why growth in New Zealand has not been more robust, Gwartney writes that:

> … while there has been some reduction in the relative size of government (and improvement in performance), New Zealand is still a big government welfare state. Government spending [central plus local] continues at nearly 40 percent of GDP, a figure much too large for maximum growth. I do not know of any country that has sustained per capita income growth of 4 percent or more with that level of government spending.[4]

3.2 Across OECD countries as a group, the share of government spending in national income has been falling significantly in recent years, as can be seen from Annex I that is based on the December 2000 *OECD Economic Outlook*. Since 1996, New Zealand has been one of only four countries that have gone against this trend, which appears to be continuing. Moreover, the ratio for New Zealand will not decline further, given the government's decision in 2000 to raise the previous government's long-term target for central government spending from 30 to 35 percent of GDP.[5] This was by far the most important decision on fiscal policy made by the government, and constitutes an effective 17 percent increase in New Zealand's underlying tax burden (government spending being a better overall measure of the burden of taxation than current revenue given fluctuations in the fiscal deficit or surplus). The divergence between Australia and New Zealand on this measure – the share of government spending in national income – is now marked and growing as the table indicates.

4 The government's priorities

4.1 The BPS states at the outset that "[f]acilitating economic growth will be a priority in Budget 2001". It also states that government initiatives in 2001 "will emphasise the quality of spending, the effectiveness of policy interventions and the relevance of the regulatory environment, rather than any relaxation of the fiscal stance … ". On page 7, the BPS adds that:

> We believe much can be done to improve the value for money that taxpayers … receive from existing government expenditure of over $38 billion per annum at 30 June 2001. Government initiatives in 2001 will also focus on improving the effectiveness of existing policy interventions, managing risks, improving the quality of government regulation, and eliminating unnecessary compliance costs.

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3 Pers comm. The experiences of Hong Kong, Singapore, Ireland and the United States in recent decades highlight the importance of institutions and policies. These issues are examined further in a forthcoming NZBR study.

4 *Ibid*.

5 The difference between this figure and the OECD figure for total outlays of 40 percent of GDP is explained by the System of National Accounts basis of measurement used by the OECD and by the inclusion of local government spending.

4.2 We endorse these sentiments and goals. Our last BPS submission was in agreement with them in stating that "[w]e believe that much current spending is ill-directed and serves to undermine rather than support economic growth and social cohesion". Achieving better overall outcomes is certainly a priority but, regrettably, the BPS does not provide grounds for confidence that the government is developing a sound growth strategy. For example, the first paragraph on page 5 under the heading "Fiscal policy supports continued economic expansion" suggests the government is relying on the upturn in exports and tourism receipts to flow through to the domestic sector. The buoyancy in the tradeables sector owes much to the real wage cuts that are implicit in the large currency depreciation that has occurred – increased profitability in internationally competing industries will not be sustained if wages rise to match the higher prices of imports and exportables. However, the same phenomenon operates in the opposite direction for the non-tradeables sector that experiences a contractionary impulse due to the higher cost of inputs from the traded goods sector and must lose resources to export and import-competing industries (this is the mechanism by which the current account deficit is reduced). Only if real wages fall relative to productivity – at the margin and on balance – can a sustained overall lift in employment and output be anticipated. In short, the growth forecasts in the BPS appear to be based on the hope that the large and unplanned fall in the New Zealand dollar will 'stick' in the sense that the effects will not be removed through wage inflation or currency appreciation.

4.3 If the government does see currency depreciation as an important part of its economic growth strategy, this is a recent change of position. A little over a year ago (December 1999) the minister of finance stated that a New Zealand dollar below US50 cents could not be justified by fundamentals and it "should rise again before too long".[6] Nor has the government (publicly at least) made clear to the union movement and workers that a currency depreciation will only have sustained effects if real wages are cut in the short term. (In the longer-term, higher real wages can be sustained by productivity improvements.)

4.4 However, far from being a source of growth, a weakening currency is commonly evidence of economic weakness. For example, any government could depress its currency through foolish policies that scare off investors. But the implied real wage cut is then associated with lowered future productivity rather than with any necessary gain in competitiveness. In contrast, low inflation and rapid increases in productivity tend to be associated with high rates of investment, economic success and currency *appreciation*.

4.5 Fundamentally, real wages in New Zealand will tend to reflect the productivity of the relevant marginal worker in any part of the labour market. The lower that productivity, the lower real wages will be in New Zealand compared with countries with superior policies. A sound growth strategy directed at the budget goal of facilitating economic growth would focus on policies likely to increase productivity and employment across the economy as a whole. The government should not count on a weak exchange rate to achieve a cut in overall real wage rates.

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6 *New Zealand Herald*, 15 December 1999, 'Kiwi on its way back up soon predicts Cullen'.

5 Implications for government action

5.1 It is easy to pay lip-service to laudable goals. The real test is credible supportive actions.

- The previous government had a longer-term growth target for GDP of 3.5–5 percent per annum, but no credible policy for achieving that target. The minister of finance has targeted a growth rate of 4 percent. We believe such a target is achievable and should be a minimum objective. As noted, however, average outcomes in recent years and the Treasury's December forecasts come in at appreciably under 3 percent. No corrective action appears to be proposed.

- The prime minister campaigned *inter alia* on reducing the unemployment rate to 3 percent. Unfortunately, many of the government's policy actions point in the opposite direction and the Treasury is forecasting that the unemployment rate will be 5.7 percent in 2005 – effectively no improvement on the rate at the time the government was elected in 1999. Again, no corrective action appears to be proposed.

5.2 The NZBR considers that New Zealand's economic and social performance will remain poor and well below its potential with present policy settings. We believe the government needs to formulate a credible growth strategy to bridge the gap between its goals and projected outcomes. This would involve resuming a reform programme along the lines recommended in recent reports by the OECD, the IMF and *The Economist*, which are in line with NZBR thinking. If the BPS statement that "[f]acilitating economic growth will be a priority in Budget 2001" is to be meaningful, the government must revisit its policy approach that has been redistributive, not growth-oriented, and characterised by higher spending, taxation and regulation. To date the government's priority has been to implement particular pre-election commitments to specific groups. In doing so, it has not established that its policies promote the interests of New Zealanders at large in generally rising living standards, and, indeed, we do not believe that it could do so.

5.3 Although New Zealand has made progress in reducing unjustified government intervention in the economy, it is important to note that the deadweight costs of taxation are still high and rising due to factors such as globalisation and mobility of capital. Skilled labour is also now much more mobile: we believe the government is out of touch with the current experience of many businesses in denying that New Zealand faces a serious 'brain drain' problem – very different from earlier 'OE' patterns. Average incomes in Australia are now some 40 percent higher than those in New Zealand, as Annex II indicates, and this gap seems likely to widen. As noted, taxation as a proportion of national income is also much lower in Australia. The pull to live and work elsewhere is much stronger than in the past, as are the opportunities. Currently the government appears committed to greatly increased expenditure ($5.9 billion over three years) and increased marginal income tax rates (the 2000 increase in the top income tax rate to 39 percent). Firms report that the latter are a significant factor in the loss of skilled people. Pressures for additional spending are apparent, yet overall outcomes in areas such as education, health and welfare dependency do not appear to be improving. Along with moves to more extensive regulation and other 'hands-on' policies, this combination of policies is so far removed as a growth strategy from current international expert opinion and prevailing policy directions elsewhere as to call into question its credibility and create major communication problems for the government with businesses and investors.

5.4 We believe current approaches are not consistent with a strategy for economic growth and better social performance. We urge the government to consider the following steps:

(i) establish a goal under the Fiscal Responsibility Act 1994 of reducing government spending to 30 percent of GDP over the next few years, as a step towards a lower target (Ireland's ratio is projected to be 26 percent by 2002).[7] Some of this reduction could be achieved by holding the rate of growth of government spending below the growth rate of the economy;

(ii) implement significant cuts in wasteful and poorly targeted government spending. Decisions in the budget will be a test of the seriousness of the government's commitment to its 'value for money' programme;

(iii) focus especially on government programmes that essentially involve 'churning' of income by taxing middle and upper income groups only to return resources to them in the form of taxpayer-provided services, either concurrently or at another point in their lives. The deadweight costs of such 'churning' are large – probably in excess of 30 cents at the margin for every dollar of taxation raised. National income is lower as a result. There would be major benefits if such groups faced lower taxes but paid more themselves for some social services (whether provided by the government or the private sector), with taxpayer funding being directed to those in greater need of assistance; and

(iv) reduce high effective marginal tax rates, as these are most harmful to economic performance and growth. There is also a strong case to reduce the burden of taxation on capital income to lower the cost of capital and encourage investment, and to flatten and simplify the income tax scale.

5.5 In addition, we urge the government to halt and reverse the regulatory juggernaut that has led in the past year to more regulation in areas such as accident compensation (ACC), employment contracts, energy, telecommunications and company takeovers. National interest tests as required by Regulatory Impact Statements are not being competently applied in the case of most, if any, of these initiatives, and New Zealand has an enormous amount of regulation (some of it of recent origin) that is stifling business development. We also endorse calls by the OECD and other advisers to resume a programme of privatisation, reduce the generosity of New Zealand Superannuation for future retirees, introduce more competition into health, accident compensation and education, and curb welfare expenditures, particularly by focusing on removing obstacles to employment and restricting the terms of access to welfare benefits. New Zealand welfare arrangements are generally more generous and lenient than those of Australia.

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7 Ireland also has the advantage of being part of the large European Union economy. To offset natural disadvantages such as remoteness from markets, New Zealand's fiscal, regulatory and other policies must be better than those of countries like Ireland to achieve comparable economic performance.

5.6 In summary, we believe that New Zealand's economic performance has been allowed to deteriorate for several years, and that current policy settings risk accentuating rather than reversing this trend. In today's more open international economy, the risks for a remote and under-performing country with inferior policies are very great. Better policies than other countries are needed to offset natural disadvantages. An accent on redistribution drives capital and people to leave. The government's more recent emphasis on the economy and relations with the business sector is welcome, but must be followed up by tangible action if it is to be meaningful. We consider that the government should see such action as an urgent requirement in formulating the forthcoming budget, and we would be pleased to cooperate in efforts to establish a more successful growth strategy.

Country ranking and 1996–2002 change	General government total outlays as a percentage of nominal GDP 1991	1992	1993	1994	1995	1996	1997	1998	1999	Estimates and projections 2000	2001	2002	Changes: 1996–2002(1)	1993–2002(2)
1 Finland	52.7	57.7	59.1	57.5	54.3	54.0	51.3	48.1	47.0	44.8	43.1	41.8	**–12.2**	**–17.3**
2 Ireland	40.7	41.2	40.8	40.6	37.6	35.8	34.0	31.8	30.9	27.7	26.7	26.0	**–9.8**	**–14.8**
3 Sweden	58.0	63.6	67.5	64.9	62.1	60.2	58.6	56.2	56.0	53.9	53.1	52.7	**–7.5**	**–14.8**
4 Canada	49.2	50.1	49.0	46.7	45.3	43.4	40.8	41.0	38.8	37.8	37.4	37.0	**–6.4**	**–12.0**
5 Denmark	54.5	55.5	58.1	58.0	56.6	56.3	54.6	53.6	52.3	51.3	50.6	50.0	**–6.3**	**–8.1**
6 Italy	53.1	53.2	56.4	53.9	52.3	52.5	49.9	48.7	48.3	46.7	47.1	46.6	**–5.9**	**–9.8**
8 Netherlands	49.5	50.0	49.9	47.6	47.7	45.6	44.4	43.3	42.7	41.5	40.1	39.8	**–5.8**	**–10.1**
9 Norway	50.6	52.0	51.0	49.9	47.6	45.4	43.8	46.4	46.2	40.6	38.8	39.7	**–5.7**	**–11.3**
10 Austria	49.6	50.3	53.1	52.5	52.4	51.9	49.5	50.1	49.8	48.8	48.3	46.8	**–5.1**	**–6.3**
11 Hungary			55.3	56.2	51.2	47.1	46.9	46.2	45.6	43.8	43.0	42.0	**–5.1**	**–13.3**
12 Belgium	51.8	51.9	53.3	51.3	50.3	50.3	48.8	48.2	47.9	46.7	45.1	4S.2	**–5.1**	**–8.1**
13 Spain	42.4	43.7	47.1	45.0	44.0	42.8	41.3	40.6	39.6	38.5	38.2	38.0	**–4.8**	**–9.1**
14 Australia	34.7	36.2	36.2	35.4	35.4	34.7	33.5	33.4	31.8	31.4	31.0	30.5	**–4.2**	**–5.7**
15 France	50.0	51.7	53.3	53.8	53.6	53.8	52.8	52.4	52.1	51.2	49.4	49.7	**–4.1**	**–3.6**
16 United Kingdom	43.5	45.3	45.5	44.7	44.4	43.0	40.9	39.7	39.1	38.4	38.8	39.0	**–4.0**	**–6.5**
17 United States	34.2	34.8	34.1	33.1	32.9	32.4	31.4	30.5	30.0	29.2	29.0	28.8	**–3.6**	**–5.3**
18 Germany	44.2	45.0	46.2	45.9	46.3	47.3	46.4	45.8	45.9	43.0	44.5	43.8	**–3.5**	**–2.4**
19 Greece	43.8	45.8	47.9	45.5	46.6	44.4	42.8	42.6	43.9	43.7	43.0	42.1	**–2.3**	**–5.8**
20 Iceland	40.1	40.5	40.4	39.9	39.2	38.6	37.2	37.8	38.8	38.0	38.6	38.2	**–0.4**	**–2.2**
21 Portugal					41.2	41.5	40.1	40.2	41.3	42.1	42.4	42.7	**1.2**	**na**
22 ***New Zealand***	***45.8***	***45.4***	***42.0***	***39.6***	***38.8***	***38.5***	***38.9***	***39.5***	***40.9***	***40.8***	***40.2***	***39.9***	***1.4***	***–2.1***
23 Japan	30.9	31.7	33.7	34.4	35.6	35.9	34.9	36.6	38.1	38.2	38.3	37.5	**1.6**	**3.8**
24 Korea	19.4	20.6	20.1	19.7	19.3	20.7	21.5	24.2	23.5	23.4	23.4	23.3	**2.6**	**3.2**
na Czech Republic							41.1	41.1	45.7	47.6	47.1	47.9	**na**	**na**
Euro Area	47.4	48.4	50.5	49.4	49.0	49.2	47.8	47.1	46.8	45.0	44.9	44.5	**–4.7**	**–6.0**
Total of above European Union countries	47.6	48.8	50.6	49.5	48.8	48.6	47.0	46.2	45.9	44.3	44.3	44.0	**–4.6**	**–6.6**
Total of above OECD countries	**38.9**	**39.8**	**40.5**	**39.6**	**39.5**	**39.2**	**38.0**	**37.7**	**37.5**	**36.6**	**36.5**	**36.1**	**–3.1**	**–4.4**
NZ as percentage of OECD	118	114	104	100	98	98	102	105	109	111	110	111		
NZ Expenditure Ratio Rank (1= lowest ratio)	12	11	8	5	6	6	8	8	11	12	13	13		

Notes:

1 New Zealand elected its first government under MMP in 1996.

2 Government expenditure in the OECD area as a whole peaked In 1993 at 40.5 percent of GDP.

Source: *OECD Economic Outlook*, No 68, December 2000, Annex Table 28.

Australia versus New Zealand – key indicators

	Australia	New Zealand	Difference	
	$	$	$	%[1]
GDP per capita at current prices US dollars in 1999:				
Purchasing power basis	25,721	18,532	7,189	38.8
Current exchange rates basis. 1999	21,492	14,376	7,116	49.5
	%	**%**	**Percentage points**	
General government spending as a percentage of nominal GDP 2000	32.7	40.2	–7.5	

1 The difference in GDP is expressed as a percentage of New Zealand's GDP.

Source: National Accounts of OECD countries, main aggregates www.oecd.org/std/gdpperca.htm, July 2001. General government total outlays as a percentage of nominal GDP, *OECD Economic Outlook* 69, Paris, June 2001.

EISENHOWER FELLOWSHIP CONFERENCE

ROLES FOR PUBLIC AND PRIVATE CAPITAL IN INFRASTRUCTURE DEVELOPMENT: NEW ZEALAND EXPERIENCE

RALPH NORRIS
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SYDNEY
13 NOVEMBER 2000

ROLES FOR PUBLIC AND PRIVATE CAPITAL IN INFRASTRUCTURE DEVELOPMENT: NEW ZEALAND EXPERIENCE

Introduction

The brief for this session notes that reliable and advanced infrastructure is fundamental to economic development. It observes that government ownership of infrastructure has decreased in many countries through privatisation. It reports that privatisation in Australia is well advanced in the electricity and telecommunications sectors, but that major problems exist in the water industry. Nevertheless, privatisation of water resources and private sector participation in government-owned water utilities is now underway. Finally, the brief notes that in many countries the public role in funding and maintaining health services is stretched to the limit, which points to the need for well-regulated private capital investment in health.

I agree with these general perspectives. There is strong evidence from international experience in a wide range of developing and developed countries that increased private sector involvement in infrastructure provision generates substantial benefits for consumers, taxpayers and the shareholders of privatised businesses.

These findings have encouraged a wide range of countries and governments to embark on privatisation programmes, with privatisation effectively halving worldwide state ownership of assets over the past two decades.[1]

New Zealand has been part of this worldwide trend. Its government moved rapidly to involve the private sector in providing and managing infrastructure in the late 1980s through to the mid-1990s. Progress then slowed and came to a standstill at the end of 1999, with the election of a government opposed to further privatisation.

Despite the documented evidence of benefits from corporatisation and increased private sector involvement in infrastructure (and other) industries, a large number of New Zealanders remain deeply sceptical about the reforms. Until the issues are openly debated, and central and local government politicians are once again prepared to lead public opinion, improvements in critical infrastructure industries in New Zealand will lag the rest of the developed world.

Case for private sector involvement

A large body of empirical research demonstrates that, on average and over time, privately owned businesses perform more efficiently than state-owned enterprises. This is true whether the businesses operate in competitive or less competitive markets. Substantial efficiency gains have also been documented for franchising and contracting arrangements.

The authors of a recent article published in the *Journal of Finance* concluded on the basis of their own research and a review of 14 studies of several thousand companies in 50 countries involving “every imaginable industry” that these “papers … speak with a consistent voice documenting privatization-induced output, efficiency, and

[1] Megginson, WL and Netter, JM, *From State to Market: A Survey of Empirical Studies on Privatisation*, working paper, University of Oklahoma, March 2000.

profitability increases". They conclude, "privatization 'works' and it works in almost every institutional setting".[2]

Academic research conducted in New Zealand supports these findings. One study found that the corporatisation and subsequent privatisation of Telecom New Zealand had resulted in substantial improvements in total factor productivity and had achieved annual real cost reductions of 5.6 percent per annum in the period 1987–1993. The gain in overall welfare (producer plus consumer surplus) from the improved efficiency of the company over this period was estimated at around $0.5 billion. The bulk of the gains accrued to consumers.[3]

Another study examined the gains from the privatisation of New Zealand Rail. It concluded that they were in the order of $1 billion to $10 billion depending on the assumed counterfactual. It noted that most of the benefits accrued to taxpayers (through not having to subsidise rail) and the firm's private owners.[4]

Anecdotal and less formal empirical evidence supports the academic research. Corporatisation and privatisation have turned many businesses from a loss-making position into sustainable profitability. Costs have been cut and performance improved. Consumers have enjoyed substantial improvements in services, and often lower prices.

The empirical results are not surprising. Businesses exposed to the disciplines of capital markets and monitored by interested owners are likely to have stronger incentives to perform than those subject to political oversight. While corporatisation and exposure to competition can improve the incentives for publicly owned businesses to perform, the sustainability of any gains is questionable given political imperatives. Politicians find it difficult to resist pursuing political as well as commercial objectives through their ownership of businesses. Public ownership inevitably risks politicisation of decision making, rent seeking and political grandstanding over prices.

Private sector involvement can clarify the commercial objectives of businesses, provide managers with better incentives for performance, improve monitoring and reduce the politicisation of business decisions. The involvement of the private sector brings skills and know-how that are not available to governments. The private sector can mobilise finance for new investments when governments are hard pressed to raise funds for the large outlays required for infrastructure investments and ill-placed to handle the associated business risk.

New Zealand reform process

New Zealand was a latecomer to privatisation of state-owned assets, including infrastructure assets, but significant moves began in the late 1980s. Petrocorp, which owned a major gas utility operation, was sold in 1988. Telecom was privatised with a light-handed regulatory regime in 1990. New Zealand Rail was sold in 1993. Most

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2 D'Souza, J and Megginson, WL, 'The Financial and Operating Performance of Privatized Firms During the 1990s', *Journal of Finance*, Vol LIV, No 4, August 1999.

3 Boles de Boer, D and Evans, L, *Government Department to Public Corporation in a Deregulated Economy: The Economic Efficiency of New Zealand Telecommunications*, July 1994. The authors note that it is not possible to separate the benefits from corporatisation and deregulation from those of privatisation. They state that they believe that at least half the benefits are attributable to privatisation.

4 Evans, L and Boles de Boer, D (principal authors), *The Privatisation of New Zealand Rail*, report prepared for the New Zealand Treasury, July 1999.

electricity distribution companies were corporatised and privatised or their ownership transferred to community trusts in the early 1990s. The government divested its shareholdings in Auckland and Wellington airports in 1998, and sold Contact Energy, a major generating company, in 1999.

Local government has largely resisted privatisation of its infrastructure assets although a few councils have sold their shares in ports and airports. The cessation of the privatisation programme by central government has left it owning and operating a number of important infrastructure assets including most electricity generation capacity, as well as the high voltage transmission system. The government also owns New Zealand Post, which is responsible for most of the postal system. The state highway roading network is owned by the government, and other roads are largely in local government control. Water utilities are primarily council-owned. The government is the dominant owner of health care facilities (outside the primary health sector that is largely private and for-profit) and is effectively a monopoly provider.

Infrastructure industries

Corporatisation improved the performance of the government's electricity and postal businesses. However, the sustainability of these gains is uncertain (New Zealand Post seems likely to be required to enter into banking, in which it has no expertise), and opportunities for further gains in operating efficiency, diversification, synergies with other businesses (including multi-utility operations) and overseas expansion are curtailed.

In relation to roading, the previous government proposed, after an extensive review, to adopt a more commercial approach. It suggested combining existing roading operations owned by central and local government into a small number of commercial companies. Pricing of road use was proposed to help manage congestion and fund expansion of the network. Privatisation was ruled out, although private sector involvement in roading (for example, through toll roads) was envisaged.

The proposed changes were strongly resisted by local authorities – roading constitutes the major activity for many of the smaller councils. The present Labour/Alliance government rejected the commercial approach, and no reforms have been made.

Road users continue to be frustrated by congestion and delays, particularly in Auckland, and no solutions are in sight. Councils routinely promote public transport options that can, at best, make only a marginal contribution to solving the problem. While the government has signalled that it might contemplate private sector investment in roading, so far there has been no action.

Local government – both regional and territorial councils – is a major owner of infrastructure including landfills, ports and local airports as well as roading, water and sewerage. Auckland and Wellington city councils have shareholdings in the Auckland and Wellington international airports. A few councils continue to own electricity businesses.

Local government has largely been hostile to commercialisation and privatisation of its infrastructure assets, although there have been a few exceptions.

Councils were required by the government to corporatise their port and airport businesses. There is a pressing need for mergers and other forms of rationalisation in the port industry, but in practice this is largely precluded by majority public ownership. Councils have corporatised and sometimes privatised the small council units that provide infrastructure-related services, particularly 'works' operations such as roading maintenance.

Only a few of the water and wastewater businesses operate in a corporatised framework. Auckland City Council's water distribution business (Metrowater) was corporatised in 1997. Watercare, the bulk water supplier in Auckland, operates as a constrained commercial entity.

Private sector involvement in owning and operating infrastructure assets is limited. Papakura, one of the smaller Auckland councils, franchised its water and wastewater operations to United Water in 1997, achieving net cost savings of around 10 percent. Wellington City Council franchised Anglian Water to build, own and operate its sewage treatment plant.

Many of the longstanding problems in the sector, including poor maintenance of pipelines, system failures resulting in the discharge of untreated sewage, high levels of losses from pipeline systems, water restrictions in many areas during summer months and poor quality drinking water in some areas, have not been addressed. Few councils have introduced usage-based pricing despite its environmental and efficiency benefits and its widespread adoption in Australia.

Dismayed at the state of the water and wastewater sector, the government initiated a review in 1988. However, in the face of strong opposition from councils, responsibility for the review was passed to local authorities in the following year. Nothing tangible has subsequently happened. Little reform appears likely unless it is directed by central government – but central government seems at present unlikely to take the lead.

The greatest area of private sector involvement at the local government level has been achieved through the contracting out of council services. Contracting out has been a consistent success story for local government – cost savings of 10 to 30 percent from contracting out are commonly cited.

Most infrastructure design and construction and a good deal of infrastructure maintenance is contracted to the private sector or, if undertaken in-house, is awarded through a competitive contracting process. Some councils have contracted out core functions such as administration, planning and regulatory services.

Health

The reforms to the health system implemented by the National government in the early 1990s envisaged greater private sector involvement in the funding and delivery of health services. Private sector competitors were expected to improve the delivery of services while supplying incentives for public providers to improve their performance. Regional and then national health funding authorities – the government's purchasing arm – achieved some limited successes in contracting with the private sector.

However, the government did not implement the full package of health reforms – failing, for example, to allow individuals to buy their own health insurance from private providers as initially intended. It prevented public hospitals subcontracting space to private providers and bailed out loss-making hospitals, undermining the incentives to cut costs. Ultimately, the semi-commercialised publicly owned model for hospitals achieved only limited gains and has proved politically unstable.

The government-dominated health sector remains characterised by poor performance – for example, long waiting periods for hospital treatment and a lack of choice (with consumers having to pay a substantial premium to purchase alternative private services). Consumer dissatisfaction is high.

The health sector is now undergoing a further set of changes initiated by the Labour/Alliance government. These unwind most of the changes implemented by the previous government. The changes will reduce private sector involvement and weaken the commercial disciplines and accountability of the monopoly government providers. Ongoing problems can be expected.

The government recently re-nationalised the accident insurance market which was partially opened up to private sector competition in 1999. This action was taken despite the large benefits achieved during the brief period of liberalisation – benefits conservatively estimated to be around $300 million a year.

Summary

Despite clear evidence of the benefits of privatisation, there are unfavourable attitudes in New Zealand to the sale or franchising of publicly owned assets to the private sector. The lack of support for privatisation is reflected in the government's anti-privatisation position and the resistance of many local authorities to privatisation.

The halting of reform stands in stark contrast to the progress in other countries, including Australia, where commercialisation and private sector involvement in infrastructure is proceeding apace.

The failure to reform government-owned infrastructure industries and the state monopolies in health and accident insurance carries a heavy penalty. The poor performance of these sectors will continue to operate as a drag on the living standards of New Zealanders and the international competitiveness of the business sector.

INDUSTRY POLICY AND REGULATION

ARTICLE BY ROGER KERR FOR THE
NZ KIWIFRUIT JOURNAL

THE KIWIFRUIT INDUSTRY IN 2001

JULY/AUGUST 2001

THE KIWIFRUIT INDUSTRY IN 2001

Two recent events highlight the implications for kiwifruit growers and the New Zealand economy of the present highly regulated regime for exporting kiwifruit.

Zespri's share offer

The first event was the under-subscription for Zespri's share offer. The offer was only 60 percent subscribed, leaving Zespri $6.5 million short of its targeted $16 million. The reluctance of shareholders to invest more funds voluntarily in the company means Zespri's preferred way of strengthening its balance sheet is reducing the payout to growers, according to comments by chairman Doug Voss in *Rural News* of 4 June 2001.

Most commercial share offerings are many times over-subscribed. While it is not unprecedented for rights issues to be under-subscribed if a company is in financial distress, the norm is for a rights issue to be fully taken up.

Of course, Zespri does not have access to the deep pool of investors that listed companies have. Only kiwifruit growers (and ex-growers) are able to hold shares in Zespri, and voting rights are now tied to current production. That ensures growers can control the export marketer. But such control comes at a cost. The costs include reduced opportunities for growers to diversify their assets and the inability of growers to get full value for their shares. The question for grower shareholders is whether the advantages of ownership restrictions outweigh the costs, that is, are the restrictions on ownership really in their interests or those of Zespri?

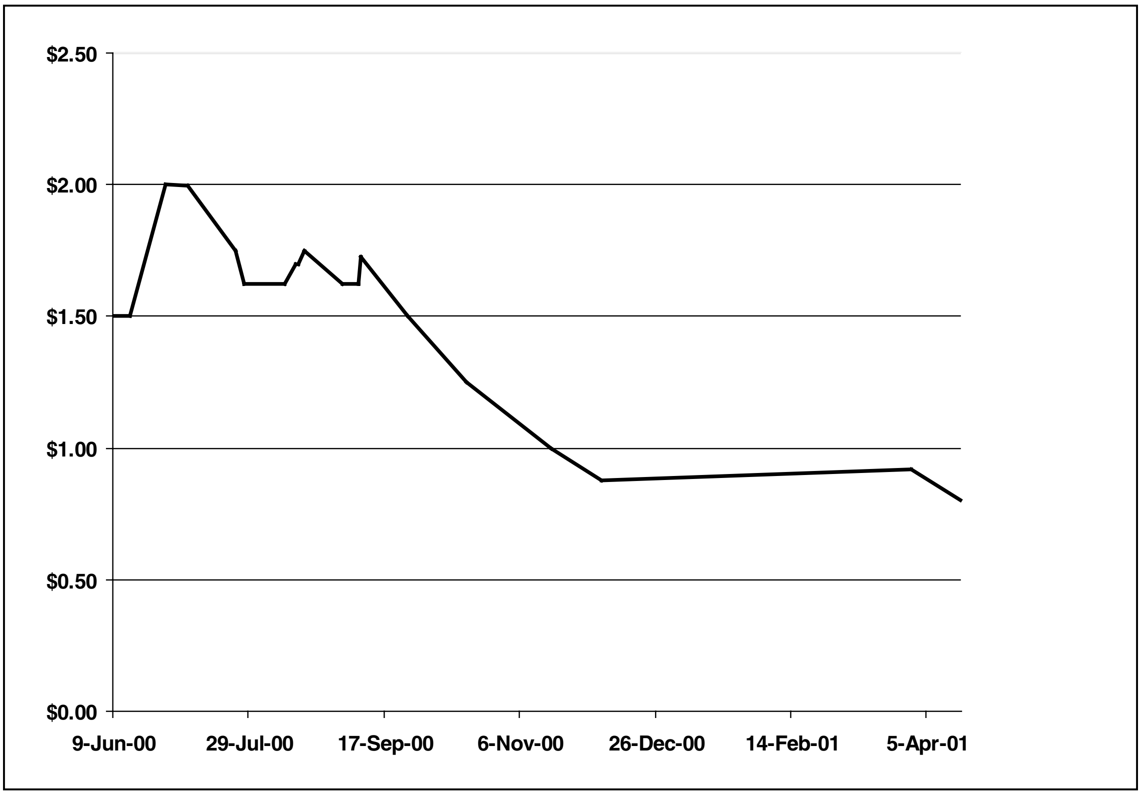
In a report 'The Value of Producers' Shares in Agricultural Cooperatives' prepared in 1999, Ord Minnett estimated that unlisted shares with constraints on ownership are likely to trade at a discount of around 30–50 percent. Shares in Zespri currently trade hardly at all, but globalregister.co.nz shows the most recent trade (17 April 2001) was at $0.80c. With 13.4 million fully paid shares, that implies a value for Zespri Ltd of around $10.7 million. The 30–50 percent discount resulting from the current restrictions on ownership means growers, in total, may be forgoing $5–10 million in value.

It may be that there are less costly ways of ensuring the security that growers want. For example, suppliers of other perishable products like grapes, peas and other vegetable produce enter long-term contracts with investor-owned firms that seem to serve growers' and processors' interests well.

Further, the choice between an investor-owned company and a cooperative is not a black and white one. There are, in fact, a whole range of organisational forms that provide different advantages to their owners at different times. Kerry Dairy of Ireland is a good example. In 1986, its supplier-farmers owned 100 percent of Kerry, a company valued at 45 million Irish punts. The farmers decided to list the company on the stock exchange while retaining a 52 percent stake through a cooperative structure. By 1996, Kerry was a successful multi-product multinational business worth 1,100 million Irish punts, and was still 52 percent owned and controlled by the farmer cooperative. Subsequently, the farmers (whose investment had increased in value over tenfold), decided, by a 75 percent vote, to sell down below a 50 percent shareholding.

It is useful to consider the performance of Zespri Ltd's share price since the shares were first traded on 9 June 2000. Data obtained from Computershare Registry Services (adjusted for the February 2001 1:2 share split) show Zespri's share price has halved over the period. This compares with the 4 percent increase in the NZSE40 Gross Index during the period.

Zespri Ltd share price



I am not suggesting that the open ownership form is always superior, or that there is an inexorable trend away from cooperatives. I noted in a paper 'Cooperatives versus Corporates' presented to the 1999 New Zealand Agribusiness and Food Congress that cooperatives and non-profit firms have important advantages in some situations. In a healthy, dynamic economy a variety of organisational forms will exist and evolve and be allowed to compete on an equal footing.

Apple industry deregulation

The second recent event that kiwifruit growers will be well aware of is the government's decision to deregulate apple exporting from 1 October 2001. This decision follows consultations that the government undertook with apple growers earlier this year. The call for change arising from those consultations was overwhelming. Only four of the 121 submissions favoured retaining single desk exporting.

The government's decision on apples finally brings New Zealand's apple industry into line with other apple exporting countries. Following the request by dairy industry leaders to remove the statutory monopsony of the Dairy Board and the vote in favour of Globalco by dairy farmers, kiwifruit exporting will be the only heavily regulated and protected export sector in New Zealand.

Kiwifruit growers may consider they have prospered in recent seasons under the current regime. But how much of that is due to factors like the lower exchange rate, good offshore prices and growing volumes of fruit supply? Leaving aside such factors, the question growers should be asking themselves is whether the benefits of the current highly regulated system outweigh the costs. In particular, does it make sense for:

- exports of kiwifruit that are in the national interest (that is, where an alternative exporter/supplier can achieve a higher return and/or offer a better service to the grower than Zespri) but are not 'complementary' to Zespri to be banned? As a result, Zespri is protected but growers and the New Zealand economy as a whole lose;

- Zespri to be subject to extensive restrictions, including rules on non-diversification, non-discrimination and information disclosure. While such constraints are required given Zespri's privileged position under the current regulations, they impede its ability to compete in the international marketplace;

- alternative exporters to be subject to uncertainty as to how long they will be allowed to export, how much they will be able to export, and to which markets? and

- the industry to be burdened by the costs of complying with 18 pages of export regulations and the additional layers of bureaucracy from having a Kiwifruit Board required to oversee the regulations and authorise so-called 'collaborative' exports?

All these costs are unnecessary and would be removed by establishing a normal regulatory environment for the kiwifruit industry.

Conclusions

Recently, kiwifruit growers have done well but the prospects for the current season look less promising. The crisis in the kiwifruit industry in the early 1990s reminds us how fragile a business commodity exporting is.

The current highly regulated regime for kiwifruit is the result of a political compromise. It is well out of line with the regulatory regimes applying to other New Zealand industries and with the regimes in other major horticultural exporting countries. Any regime that denies even a minority of industry participants the freedom to go about their business differently is draconian and hard to justify. It would be regrettable if the New Zealand kiwifruit industry had to go through the pain, strife and costly lessons the apple industry has been through before it too seeks an open competitive export regime.

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION TO THE PRIMARY PRODUCTION COMMITTEE

DAIRY INDUSTRY RESTRUCTURING BILL 2001

JULY 2001

1.0 Introduction

1.1 This submission on the Dairy Industry Restructuring Bill 2001 (the Bill) 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 The NZBR has investigated at length the appropriate public policy environment for New Zealand's agricultural exporting sector. It is almost a decade now since the release of the report *Agricultural Marketing Regulation: Reality versus Doctrine* that it commissioned from the consultancy firm ACIL. That report highlighted the costs to the New Zealand economy of the single-desk export monopolies and producer board structures. The ACIL report was highly contentious at the time with the boards vigorously defending their statutory privileges. It was followed by four further NZBR reports on dairy industry issues,[1] together with many other papers and submissions.

1.3 The general thrust of the approach advocated by the NZBR has now become mainstream. As the Explanatory Note to the Bill states, it is "now widely acknowledged that … the current regulated structure of the New Zealand dairy industry is … unsustainable". The Explanatory Note further states that "removing restrictions on exporting New Zealand dairy products will stimulate investment and innovation in the New Zealand dairy manufacturing and exporting sector".

1.4 These are points that the NZBR has been making for years in the face of criticism from industry and national politicians. It is lamentable that the delays in making the changes have probably cost the industry and the economy hundreds of millions of dollars in potential income forgone.

1.5 Equally disturbing is the amount of ongoing confusion as to why changes to New Zealand's agricultural exporting arrangements are needed.

1.6 A case in point is the claim by some supporters of Globalco that the international agribusiness market is somehow analogous to a rugby test match. They ask the question: "If you were going to do battle with the rest of world, would you rather back Waikato, Taranaki or the All Blacks?" as if this were a description of the commercial reality of international markets.

1.7 This analogy is naïve on several counts:

- unlike national rugby teams, the world dairy industry is not divided on nationalistic lines. Companies like Nestlé, Parmalat and Danone do not limit themselves to raw materials and resources of Swiss, Italian and French origin respectively. They pick the best ideas, the best products and the best talent from around the world;

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1 *The Economy-wide Effects of Bundling Milk and Non-milk Returns*, by Tasman Asia Pacific Pty Ltd, July 1996; *The Dairy Board's Export Monopoly*, by Winton Bates, September 1997; *Farmer Control of Processing and Marketing: Does it Serve the Interests of Farmers?*, by Winton Bates, August 1998; and *Reform of the Domestic Market for Dairy Produce: An Analysis of Progress and Issues*, by Frank Scrimgeour, November 1998.

- unlike the All Blacks, Globalco will be a vertically and horizontally integrated monopoly. If there is a rugby analogy, Globalco is akin to abolishing the Super 12 and club rugby and having a single rugby team with one vision, one coach and one set of tactics to take on international competition; and

- economies of scale are typically important in some parts of some industries, including dairying, but not in others. Bigger is not necessarily better in commerce. Where larger firm size matters this should be a matter for commercial decision making, subject to normal competition rules, not a matter of legislative fiat or sanction.

1.8 In fact, the choice for Waikato and Taranaki dairy farmers as owners of the dairy cooperatives is not between going it alone or teaming with each other. The relevant question is what alliances and relationships with other companies from anywhere in the world would add most value to each of the New Zealand Dairy Group and Kiwi Cooperative.

1.9 Despite such confusion and the serious weaknesses in the Bill outlined below, the removal of the export monopoly is nevertheless a breakthrough. It will allow serious competition and outside investment in the exporting activities of the industry for the first time in almost 80 years. Alternative forms of business will also be able to evolve in the dairy processing and marketing sectors.

1.10 What is so disappointing after all the lost time and tortuous debates is that the outcome in the Bill is of such low quality – while it amounts to a pass, it is a C minus result rather than the A grade outcome that the government ought to be promoting. It is inferior to the 1999 Dairy Industry Restructuring Act based on the mega-cooperative proposal (which itself warranted little more than a B minus grade).

1.11 Accordingly the NZBR strongly urges the committee to make substantial changes to the legislation (as outlined below) to achieve a superior outcome to the benefit of the industry and the wider economy.

2.0 Commercial strategy and structure

2.1 A clear distinction must be maintained between commercial and public policy issues when assessing dairy industry reform. Commercial issues are rightly the business of dairy farmers, as owners of the processing and marketing arms of the industry. Their own money is at risk, and they and the dairy company directors and managers who are their agents should make the judgments about where to invest, what products to supply and how best to structure their business.

2.2 From a commercial perspective there appear to be many serious weaknesses in the proposed structure and governance arrangements for Globalco compared with those that we understand were recommended in the 1998 McKinsey study. Critically, Globalco does not have the key prerequisites identified by McKinsey of:

- shares that are tradable among farmers. Instead, ownership of Globalco is to be strictly linked to supply. Farmers will not be able to remain suppliers to Globalco if they want to sell their shares in the company because, for example, they do not agree with the company's strategic direction or consider its management competent. In theory farmers will have the ability to exit Globalco and take the 'fair value' of their investment with them. But fair value will be a slippery concept: it is to be an administered – not a market-determined – price.[2] Moreover, if too many farmers – more than 5 percent in any year – consider Globalco is performing poorly and want to leave, the directors of Globalco can alter the value the exiting farmers receive;

- a normal company structure for value-added activities such as consumer products, biotechnology, and new specialised ingredients. Instead, Globalco is be a hybrid cooperative with a highly complicated financial structure involving standard cooperative company shares, peak notes, capital notes, redeemable preference shares and supply redemption rights. Much of this complexity is to give Globalco the ability to get around having to pay farmers in cash the fair value of their shares when they exit – even though farmers have to pay cash in full when they enter the industry;

- access to outside shareholders for the capital needed for high-risk growth activities. McKinsey estimated that $12 billion of new capital would be required if Globalco is to meet its targets, including $4 billion of new share capital. That kind of growth is simply not possible with shareholding restricted to dairy farmers. It would require an additional capital injection of around $275,000 from each of New Zealand's 14,500 dairy farmers;

- a large proportion of independent directors. Instead, only three of Globalco's 13 directors are to be non-dairy farmers and those three are to be tightly constrained. New Zealand's largest company will depend for its governance on a group of people with very limited major company experience and expertise;

- dynamic, fresh management starting with a clean slate and a "new performance ethic". Instead, internal senior management appointments are being made; and

- an independently set raw milk price. Rather, the milk price will be set by Globalco.

2.3 Not having researched the commercial aspects of merger options in the industry, the NZBR has no view on the quality of McKinsey's work or its overall conclusions. Nevertheless, these prerequisites clearly have force and in McKinsey's opinion were critical if the single cooperative model is to be successful and the risk of monopolistic inefficiencies intrinsic in the structure are to be mitigated. Even then the gains from this highly risky structure were estimated to be only $180 million per annum or 2 percent of the industry's annual revenue. If these pre-conditions were not met – as they are not under Globalco – McKinsey estimated at the time that the gains from the single

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[2] As Globalco's own invited international expert on cooperatives, Dr Zwanenberg of agribusiness bank Rabobank, said, "GDC's fair value is hard to fathom ... if it takes me so long to understand it cannot be clear enough".

cooperative structure would be about $800 million per year less than one involving two competing firms.

2.4 However, at the end of the day whether the two major dairy cooperatives ought to merge and on what terms is a commercial decision. *Provided it is subject to normal commercial law*, it is a matter for the shareholders of the two companies to determine. It is of course risky for New Zealand's dairy farmers to put all their 'eggs' in the one basket. If the merger goes ahead, farmers will forgo the benefits of competition between two or more different commercial visions, strategies, management teams, organisational forms and structures. They will also forgo the benefits of being able to compare the payments of the different dairy cooperatives. But a corporate merger under normal business law is not a public policy issue. On the other hand, public policy issues are most definitely the business of others, including parliamentarians and the wider community.

3.0 Public policy issues

3.1 The Dairy Industry Restructuring Bill is not just a 'farming' issue. The proposed merger is a very significant business transaction and raises many issues of public policy. Globalco will be New Zealand's biggest company. How well it uses the capital, land and water, electricity, plant and machinery, intellectual property and human skills and energy at its disposal will impact on the performance of the economy as a whole.

3.2 Much of the Bill is similar to the 1999 Dairy Industry Restructuring Act. However, there are several significant backward steps compared with the 1999 legislation (which was by no means an ideal benchmark).

3.3 **Commerce Act exemption**

3.3.1 To exempt Globalco from the Commerce Act 1986 as proposed in the Bill is, in our view, quite indefensible. It is a return to old-style industry favouritism and privilege. Such an exemption was not part of the 1999 legislation.[3] Business community opinion is clearly opposed to the proposed breach of normal commercial law.[4] It is totally inconsistent with the direction of the government's competition policy that is ostensibly aimed at strengthening the powers and role of the Commerce Commission.

3.3.2 It is simply wrong to claim, as some dairy industry leaders have, that the Commerce Commission is not able or well suited to handle mergers of exporting firms. The commission is charged with considering only New Zealand interests. These are not just the interests of domestic consumers of milk products; in its preliminary determination on the mega-cooperative proposal the Commerce Commission identified several markets, including notably the market for the processing of raw milk, where competition factors needed to be assessed. Any gains New Zealand achieves from exerting market power in other countries would be treated as a benefit in the commission's benefit-detriment assessment. There is no reason why the Commerce Commission

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3 The 1999 Act did not put the mega-cooperative in place. It allowed for the merger to happen by *contract* between the participating cooperatives, subject to Commerce Commission approval.

4 A poll of 303 businesses in the greater Wellington region conducted by *The Evening Post*-BRC Marketing and Social Research showed 75 percent of respondents opposed legislation allowing the dairy merger to bypass the Commerce Commission, *Evening Post*, 30 April 2001.

cannot deal adequately with the dairy merger. Indeed, that is exactly what it has been set up to do.

3.3.3 It is also wrong to claim that Globalco need not be subject to competition law because it is a cooperative. Monopolies tend to become inefficient and ineffective, regardless of corporate form.

3.3.4 No other OECD government would be likely to grant an exemption from its competition watchdog for a business merger creating the country's biggest company. Some in the dairy industry like to draw a parallel between the formation of Globalco and the merger of the giant Danish and Swedish cooperatives, MD Foods and Arla, to form Arla Foods, Europe's biggest dairy company. What is not pointed out is that the Scandinavian merger was approved by the competition authorities in Denmark, Sweden and several other European countries.

3.3.5 Time is not an issue. The Commerce Commission has a statutory requirement to process authorisation applications within 60 working days. While the commission and the applicant can agree on an extension to the timetable, it is hard to see how any sound alternative evaluation could be done more quickly than by a body that is explicitly set up for this purpose. The proposed General Electric-Honeywell merger has already been before competition authorities in the United States and Europe for around a year. Governments insist on close, transparent and independent scrutiny of proposals involving very large firms because their potential consequences for national welfare are enormous.

3.3.6 It has to be asked what is so special about Globalco that it should be exempt from the commission process? If the two main South Island meat processors, Alliance and PPCS – both cooperatives – were to merge, would they be exempted from the Commerce Commission? Would the government contemplate exempting any proposed merger of Air New Zealand and Qantas – both export-oriented businesses – from Commerce Commission scrutiny? Former government official Tony Baldwin has suggested that "Globalco is not special, it is simply weak – and the leadership don't want that fact to be publicly exposed".[5] The point is not that any proposed merger should be blocked – if it meets the requirements of the law it should be allowed to proceed. If it does not meet them, the merger parties will have the opportunity to consider modifications required by the commission. These would be aimed at bringing the proposal into line with overall national interests. This is exactly what happened with the recent acquisition of Fletcher Energy by Royal Dutch Shell.

3.3.7 The bottom line is the government should follow due process and allow the normal Commerce Act 1986 rules to be applied to the proposed merger. If the benefits of Globalco are as clear as dairy industry leaders assert, what do they have to fear from the Commerce Commission? Under the commission's voluntary notification procedure the parties do not even need to seek commission approval if they are confident the proposal meets the standard competition tests. Equally, the commission has powers of injunction that it could exercise if it were sceptical of that view. The government and other commentators, wrongly in our opinion, have talked about 'Wild West' features of New Zealand's commercial law. Setting aside the rule of law in respect of

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5 Tony Baldwin, 'Fear dogs dairy industry', *New Zealand Herald*, 3 April 2001.

New Zealand's largest ever merger could be described in those terms with far more justification, and could seriously damage New Zealand's international business reputation.

3.4 **Unbundling of returns/delinking of supply and shareholding**

3.4.1 Farmers have at least five separate investments in the industry, including in the farm, the cooperative milk processor, the Dairy Board, other overseas ventures and returns from export quota. Returns from each investment are lumped together and are bundled with the price farmers receive for the milk they supply. Thus, for example, if the Dairy Board does well from an overseas joint venture processing South American milk, New Zealand dairy farmers receive a higher price for their milk, encouraging them to produce more milk and increasing the price of New Zealand dairy land. At the same time, world dairy prices could be falling, which ought to trigger an opposite response (if the outlook remained poor).

3.4.2 These confused price signals distort production and investment decisions in the economy. At the margin, resources move into dairying that would yield a greater return to the nation in other uses. This has led to the problem known in the industry as the 'wall of milk' – the cooperatives see themselves having to invest in additional milk processing capacity at poor rates of return to manage the extra milk coming their way. The incentive to over-production has also exacerbated the environmental damage done by the dairy industry as farmers are encouraged to convert more land into dairy and to maximise the milk output on their farms.

3.4.3 A 1998 estimate suggested that the economic loss from this bundling of returns could be as high as $480 million per annum.[6] The proposed dairy industry restructuring will only partially address this problem. Farmers' assets may be unbundled by allowing fair value exit, but Globalco will face strong incentives to keep that 'fair value' exit price well below the true market value of the shares. Globalco is likely to wish to keep its milk price up (to deter new entrants into processing and marketing) and the return on farmers' capital down (so as to deter exit). Further, with shareholding linked to supply, the income the farmer receives will continue to depend solely on the production of milk, regardless of how the payments are split up and labelled. If the farmer wants to get a greater share of returns from Globalco's offshore investments, the only means will be to increase production of New Zealand milk.

3.4.4 This situation is unsustainable. It will have to be addressed if the industry is to achieve its global aspirations. But until it is, serious misallocations of resources will continue as Globalco is forced to invest in additional low-returning plant to process extra milk and as farmers are encouraged to invest in ownership of land rather than shareholding in a commercial business. Arguably the distortions are so great and have such an effect on conditions of competition in the industry that the Commerce Commission would be forced to confront this issue and require changes to the merger proposal if it came before it. This does not necessarily mean that Globalco would need to demutualise – there are plenty of corporate structures that maintain cooperative principles while giving farmers the right price signals. But it does mean that Globalco would have to adopt a

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6 Bates (1998), *op cit*, p 6.

structure that showed much more clearly how it is performing and allowed dairy farmers (as shareholders) to discipline its managers for poor performance.

3.5 Organisational form

3.5.1 The Bill (for example, Part II, Subpart V) assumes that Globalco is and will remain a cooperative and it assumes that shareholding in Globalco is based on supply. But what will happen if – as is happening in many industries around the world – the shareholders of Globalco choose at some time to demutualise?[7] The industry will have to go back to parliament and expose its operating environment to political decision making again.

3.5.2 Even changes in Globalco's capital structure will be restricted by the highly prescriptive nature of the Bill. It is based on a complex capital structure, including preference shares, peak notes and capital notes. What will happen if circumstances change and Globalco wants to change its capital structure? Again, the risk is that the dairy industry will have to return to parliament to resolve what should be a routine commercial issue.

3.5.3 Further, Globalco is likely to be registered as a cooperative under the special dairy company section (Part III) of the Cooperative Companies Act 1996. As a result, Globalco will have even greater legislative restrictions on its governance and operations than normal cooperatives. The only purpose Part III serves is to further politicise the dairy industry and the governance of its business operations. Part III of the Cooperative Companies Act 1996 should be abolished – as it was to be under the 1999 Dairy Industry Restructuring Act.

3.6 Quota

3.6.1 The Bill grants Globalco exclusive rights for six to nine years to export to 11 designated markets where New Zealand is perceived to obtain quota rents. While it is important to preserve the quota rents in New Zealand hands, there is no economic rationale for granting Globalco sole rights to the quota markets. New Zealand dairy farmers could receive the value of the quota rights directly by granting them shares in a quota holding or quota allocation body (akin to the Quotaco established in the 1999 legislation). Granting Globalco the quota rights would increase its market power further, allowing it use the quota rents to cross-subsidise its other activities and keep competitors out.

3.6.2 The list of markets for which exclusive access is designated (Schedule 5) generally looks sound given New Zealand's international quota rights. However, a major exception is the exclusive right given to Globalco to export natural cheese to Japan until March 2010. This market should not be included as a designated market in Schedule 5 of the Bill. New Zealand has no country-specific tariff quota for natural cheeses into Japan. If the Dairy Board has sound relationships with Japanese importers, these will give Globalco a commercial advantage and there is no need for statutory protection of this commercial

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[7] According to the *Australian Financial Review*, Australia's largest dairy cooperative, Dairy Farmers, is planning a restructure that will see it split into a wholly farmer-owned supply cooperative and a separate processing group that is expected to seek ASX listing. See 'Agribusiness sector a hotbed of activity', *Australian Financial Review*, 16 May 2001.

position. If anything, the bias in the definition of designated markets should be to strengthen rather than diminish the limited competitive pressures Globalco will face in its early years.

3.7 Tax

3.7.1 The Bill grants extensive special tax concessions to the dairy industry. The Dairy Board's Available Subscribed Capital of $840 million is granted to Globalco, and the Globalco merger and the restructuring of the Livestock Improvement Corporation and Dairy Research Institute are exempt from income tax and gift duty. These provisions were part of the 1999 legislation. On top of all that, the 2001 Bill proposes that tax losses of individual cooperatives be able to be carried forward to Globalco.

3.7.2 Such tax concessions are not available to other businesses when they restructure. Nor is the cost of these concessions to the general taxpayer transparent. The tax concessions to the dairy industry will do nothing to foster economic growth as they must be paid for by higher taxes on other businesses and individuals. We strongly object to privileged tax treatment for the dairy industry and submit that normal tax law should apply to the merger.

3.8 Regulatory package

3.8.1 A serious downside to the draft legislation is that dairying will remain a heavily regulated industry. The aim of many was to get the government out of the industry but this goal has far from been achieved. The new legislation runs to 114 pages, with the regulations still to come. There is extensive regulation-making power while Globalco is dominant (that is, until other players have at least 12.5 percent of milksolid supply in the North Island and at least 65 million kilograms per annum of milksolid supply in the South Island – with at least 25 million kilograms per annum having to be east of the Southern Alps).

3.82 These regulations are claimed to be necessary to keep Globalco honest and protect farmers and others while Globalco is dominant. However, a great deal of evidence suggests that the intrusive regulation of monopolies is very much a second-best solution compared with an open and competitive market subject to standard competition policy. Globalco will have strong incentives and the ability to manipulate the regulations to its advantage. It will have a monopoly on critical information. Design and enforcement of the regulations, however well-intentioned they may be, will be extremely difficult. Further, the government will retain powers to impose further regulations while Globalco is dominant. The reality is politics will remain a feature of life in the dairy industry under Globalco.

3.9 Public policy risks

There are significant policy risks in the government sanctioning the merger. If Globalco fails, the government may be seen to be at fault for not subjecting the merger to the Commerce Act 1986, regardless of whether farmers wanted it at the time or not. Further, if Globalco fails, many may draw the wrong conclusion about why it failed – preferring to blame the removal of the single desk for farmers' plight, rather than the exposure farmers face with all their 'eggs' (as both suppliers and investors) in the one basket. Finally, there is the risk of calls for further regulatory intervention as 'fair value' for shares becomes disputed and as other tensions glossed over by the political compromises underlying the Bill unfold.

4.0 Conclusions and recommendations

4.1 The removal of the statutory privileges of the Dairy Board presents an opportunity for the government to bring the regulatory environment for the dairy industry into the twenty-first century. With the exception of the special provisions needed for quota markets, the industry should be normalised and made subject to the same commercial laws as govern other industries. The industry should be set up on a basis that is free from special regulation and political interference so that it can focus on its commercial operations and maximise the wealth of its stakeholders. Unfortunately the Bill falls well short of this desirable benchmark.

4.2 The key positive feature of the legislation is the removal of the single-desk export monopoly, which is long overdue. Opening up the industry to competition and foreign investment and allowing alternative organisational forms to evolve are steps in the right direction. Exempting New Zealand's biggest ever merger from the Commerce Commission would, however, be a huge mistake. The government risks replacing one monopoly with an even bigger one. With control of 22 percent of New Zealand's exports, Globalco could end up being New Zealand's equivalent of a South Korean chaebol.

4.3 Accordingly we recommend that:

- the single desk and other statutory privileges of the Dairy Board be removed as soon as possible;
- the proposal to merge the two major companies not be exempted from the normal requirements of the Commerce Act 1986;
- the export quota rights be allocated to an independent farmer-owned body;
- exports of natural cheese to Japan be removed from the list of designated markets in Schedule 5 of the Bill;
- the dairy industry not be granted any special tax privileges;
- Globalco be required to pay out exiting farmers in cash in full when they leave and the statutory references to preference shares and capital notes be removed;
- Globalco be required to set up New Zealand Dairy Foods with an independent milk supply from the date of sale; and
- the dairy industry be established under the same laws that apply to companies and cooperatives in other industries in New Zealand.

PUBLIC LAW CONFERENCE 2001

POPULIST POLITICS AND PARTISAN INTERESTS

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5 APRIL 2001

POPULIST POLITICS AND PARTISAN INTERESTS

Introduction[1]

All governments, even extortionist governments, have an interest in a healthy and productive business sector.[2]

But governments have other priorities too.

When governments pass regulations they put compliance with those regulations ahead of anything else. Providing value for money, being competitive, making a profit fall into the 'anything else' category.

For example, the requirement to take 'all practicable steps' to ensure a safe workplace comes before being healthy and productive. So do the requirements to:

- bargain 'in good faith';
- comply with a complex tax code;
- comply with over 27 statutes that impinge on a decision to become an employer;
- comply with 33 statutes that impinge on merchants;
- comply with at least 40 statutes that affect medium-sized businesses;
- comply with 160 pieces of legislation in the case of Telecom;
- comply with fuzzy environmental legislation;
- make 'energy efficient' investments rather than commercially efficient investments;
- comply with fair trading legislation and fair advertising laws; and
- comply with privacy laws and forced disclosure laws.

Moreover, if there is a perception that the business community is failing to perform, the government will be there to:

- tax it more heavily in order to channel money back to firms so as to boost spending on research and development (R&D), or corporate welfare more generally;
- regulate takeovers with the effect of making it harder for shareholders to throw out non-performing boards and management teams;
- set up a state bank to compete with it, with the risks falling on small existing financial institutions and taxpayers, some of whom otherwise fund private firms; and

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[1] This paper is based on work the author is doing for a forthcoming report for the New Zealand Business Roundtable on the topic of regulatory reform.

[2] Refer to Mancur Olson, *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships*, Basic Books, 2000, for an analysis of the rule of government (as distinct from the rule of law).

- accede to pressures to adopt more Australian regulations, partly on the grounds that all its regulations must be at least as good since it is wealthier.

The supply of and demand for regulation

The demand for regulation is insatiable.

Businesses commonly seek regulation that has an anti-competitive effect or creates a privilege for them or their sector relative to others. This is particularly evident in the antitrust area, notably telecommunications.[3]

Special interest consumer groups lobby for labelling, safety, or environmental regulations that benefit them while spreading the costs around all consumers.

Consumers lobby for 'free' services at the expense of taxpayers.

Worker groups lobby for labour regulations that will benefit them at the expense of the unorganised or unemployed.

Professional groups lobby for special privileges in the form of occupational licensing.

Government agencies, organised on a special interest basis, will naturally lobby for regulations and government spending programmes that serve the interests to which they owe their existence. Government science agencies will lobby for more resources for science. The Ministry of Women's Affairs is unlikely to regard lower life expectancies for men or poor educational attainment for boys as a priority. Nor would the Ministry for the Environment be expected to lead the fight for compensation for regulatory takings that favour environmentalists.

Ideas play a role. Sir Geoffrey Palmer and Matthew Palmer expressed it this way:

> New Zealanders tend to exhibit an innocent and misplaced faith in the efficacy of legislation. We also undervalue the importance to the community of good law flowing from good law-making procedures. We seem to be addicted to passing legislation for the sake of it, and to believe that legislation can cure our innermost ills. This superfluity of legislation is in part a response to political demands. The government must be seen to be reacting; if it passes a law it can be said to be doing something. In response to other pressures, legislation is passed for which there is no legal need. As a respected New Zealand judge, Sir Alexander Turner, wrote in 1980: 'The belief is widely held, that there is no human situation which is so bad that legislation properly designed will effectively be able to cure it'.[4]

The idea that pre-existing laws might have served societies well for centuries is often largely overlooked in the enthusiasm to bring in a new regulation.

> In the twentieth century, the common law of England, of the United States, and indeed of every country that has adapted English common law

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3 Yet in New Zealand, the restraint shown by major business organisations in this respect is truly remarkable in an international context. Where else do counterpart organisations support free trade with zero protection for industry?

4 Palmer, Sir Geoffrey and Palmer, Matthew, *Bridled Power: New Zealand Government Under MMP*, Oxford University Press, third edition, 1997, p 150.

> to its needs, steadily gives ground before the advance of statutory law. Some legislators scarcely seem aware that the common law still exists, and they succeed in enacting statutes which deal in less satisfactory fashion with subjects already adequately covered by common law.[5]

In any democracy, most politicians are concerned to please enough voters to get re-elected. Regulation turns Say's law on its head: demand generates legislative supply. Supply only has to be politically productive. It need not be economically or socially productive.

Parliaments have not failed the law of political supply and demand. The New Zealand statute book contains around 2,000 public, local and private acts, comprises 89 volumes and totals around 65,000 pages. Regulations are something else again. There are around 2,000 statutory regulations, not including amending regulations.

Back in 1978 the statute book was more like 60 volumes and 48,000 pages. In 1951 only around 500 Acts were in force.

This truly monumental volume of intrusive regulation requires endless amendments and modifications to reflect changing circumstances, new enthusiasms and the correction of earlier errors. For the past 20 years around 4,000 pages of statutes and regulation split almost equally have been passed on average each year. There is no strong trend in the number of statutes passed in the last two decades, but there does appear to be an upward trend in the number and pages of regulations.

But hasn't New Zealand been both vilified and extolled for deregulation since 1984? Yes, and there is ample evidence that the gains from this deregulation have been very significant. Much empirical evidence at the sectoral level has been reported by researchers at Victoria University of Wellington, most recently at the New Zealand Institute for the Study of Competition and Regulation and by Professor Erwin Diewert and Denis Lawrence.

Diewert and Lawrence's study included some encouraging statistics on economy-wide productivity aggregates, as do some Reserve Bank of New Zealand articles.[6] The latest OECD report on New Zealand noted that "the comprehensive economic reforms have seen potential output improve appreciably in the 1990s compared with the 1980s", referring to a growth in potential output of 2.3 percent a year compared with 1.4 percent.[7]

However, bursts of reform in New Zealand are the exception, not the rule. Sir Robert Jones summed up the overall story with characteristic insight, colour and vigour several years ago:

> The great myth of contemporary New Zealand is that over the past fifteen years we have undergone a massive de-regulatory process. Nothing could be further from the truth. What in fact has happened is that the state has

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5 Russell Kirk, *The Roots of American Order*, Regnery Publishing, third edition, March 1992. The citation is from the American Freedom Library version, p 192.

6 See 'We're not doing all that badly: our economic performance in the 1990s compares well with Australia's when Denis Lawrence and Erwin Diewert measure productivity', *New Zealand Herald*, 11 August 1999 and, as an example of the Reserve Bank's work, the *Reserve Bank Bulletin*, Vol 61, No 3, p 200.

7 OECD *Economic Survey: New Zealand*, December 2000, p 63.

removed itself from ownership and therefore direct authority of the larger commercial enterprises; of aviation, insurance, banking, rail, shipping and so on.

But having abandoned these activities to the private sector it then through the relevant bureaucracies substituted a previous management process with a regulatory process. This rule-writing fervour has been contagious and has led to an orgy of social engineering type regulations, all of which are doomed to failure … personal responsibility has been replaced by an enormously costly set of rules covering every contingency, in many cases for all practical purposes totally unnecessary. This is particularly true of safety rules.[8]

Who should be worried and why?

Those who want to see New Zealanders prosper should be worried if the costs of any regulations exceed the benefits.

- Abuses of the Resource Management Act 1991 (RMA) are so rife that property developers are voting with their feet and taking their projects overseas, according to a major property investor.[9]
- A survey of US companies operating in New Zealand found that New Zealand is missing out on millions of dollars of foreign investment because of cumbersome RMA compliance procedures.[10]
- "Most Maori-owned land never gets developed because of red tape".[11]
- According to the executive director of the New Zealand Minerals Industry Association, government red tape is to blame for the low level of exploration activity in New Zealand.[12]
- A parliamentary select committee inquiry in 1999 found 'harrowing' evidence of the emotional and financial destruction of small business owners at the hands of the Department of Inland Revenue.
- Similar stories of emotional and financial distress accompany the enforcement of the RMA, the Health and Safety in Employment Act 1992 and the Hazardous Substances and New Organisms Act 1996.
- Even road projects that have strong local community support get bogged down by numerous hearings and appeals.

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8 Sir Robert Jones, 'Some thoughts on Standards, Bylaws, Laws and other Regulations', *Standards*, publication of Standards New Zealand, June/July 1999, p 5.

9 Campbell McIlroy, 'Developers fear no end in sight to resource management abuse', *National Business Review*, 2 March 2001, p 17.

10 *New Zealand Herald*, 15 January 1998.

11 Kelly Blanchard, 'An example to other Maori', in 'Rotorua: A great place to do business', March 2001, Business Development Unit, Rotorua District Council. (The issue relates to fragmented ownership.)

12 *Otago Daily Times*, 'Cut red tape: mining lobby', 26 February 2000.

Those who want to prosper personally but who cannot readily migrate should be worried, because it is harder to prosper in an environment that is hostile to business development.

Those who desire greater safety and a cleaner environment should be worried because there is ample evidence that these come with prosperity.

Those who seek security from government benefits and pensions should be worried, because less prosperity means less tax revenue.

Those with compassion should be worried, because bad regulations can destroy people's lives, emotionally and financially. According to a senior lawyer, businesses can be liable for devastating fines even if they are following best practice.[13]

Those who want to uphold civil society should be worried, because regulatory excesses undermine the rule of law.

The remainder of this section elaborates on this last point.

Socrates wisely said that laws should be clear and known in advance, that citizens should have an opportunity to criticise them and that there should be a means for having them changed. Aristotle explained why the rule of law is preferable to the rule of a ruler.

Law professor Geoffrey Walker, formerly of the University of Queensland, identified at least three distinct senses in which the rule of law term is used. The rule of law is assumed to prevail when:

- there is a state of law and order, as distinct from a state of anarchy;
- the legality of governmental actions is determinable by independent courts of law; and
- there are limits to the scope of legislative power.

Walker states that "The rule of law is in fact an essential precondition for all civilized life".[14]

Paul Johnson, reviewing for the *Wall Street Journal* some of the most significant trends in the last millennium, asserted that:

> The most important political development of the second millennium was the firm establishment, first in one or two countries, then in many, of the rule of law.[15]

Abraham Lincoln described the rule of law as:

> … the greatest barrier against despotism ever conceived by the human mind.

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13 Susan Bambury, 'Laudable aims, serious results', *The Independent*, 14 March 2001, p 21.

14 Geoffrey Walker, *The Rule of Law: Foundation of Constitutional Democracy*, Melbourne University Press, 1988, p 395.

15 Paul Johnson, 'Laying Down the Law', *Wall Street Journal*, 10 March 1999.

Rulers subject to the rule of law cannot use the coercive powers of the state arbitrarily to bolster their own position or that of their supporters at the expense of the community at large. Unless those who wield power conform to rules and laws that they cannot amend at will, their powers are unlimited and tyrannical.

The presence of the rule of law implies an attitude of restraint, respect by all individuals and groups of an obligation to comply with the law, and the absence of arbitrary coercion by governments or any other groups.

Edmund Burke famously stated in 1780 that bad laws are the worst sort of tyranny. Three years earlier he made the point that people who are crushed by the law will be enemies of the law and will have "no hopes but from power". Bad laws polarise and politicise.

No one could credibly claim that farmers, fishermen and small businesses can hope to comply knowingly with the barrage of legislation outlined in section 2. They fly blind. Yet the penalties for flying blind and getting something wrong are potentially crippling.[16] Many have been so crippled.[17] More will be.

A fundamental problem is that when governments create privileges for one interest group at the expense of another, or of the general populace, they undermine their fundamental role of preserving the rule of law. Others must then either play poacher or be game. Bastiat made the point forcefully in 1850:

> As long as it is admitted that the law may be diverted from its true purpose – that it may violate property instead of protecting it – then everyone will want to participate in making the law, either to protect himself against plunder or to use it for plunder.[18]

Much legislation makes some people the instruments of other people's ends – for example, the denials of an obligation to compensate, the motivations for the new 39 percent tax rate, the insatiable demands on businesses to pay for benefits for workers (for example, paid parental leave), consumers or environmentalists, and the welfare system. Yet it is a fundamental principle of democracy that the consent of those who are to be taxed is obtained.

The recent adoption of the 39 percent tax rate was arguably a watershed in that it established decisively that the issue of consent had become irrelevant. A political majority imposed a more penal tax rate on a minority simply on the grounds that it had the right to force them to pay more. No case was made that the tax was in the interests of the minority.

What might be done?

Palmer and Palmer offered the following advice on where New Zealand needs to head:

There are a good many things about which it is better not to legislate. Legislation gives the state its legitimate authority to exercise its coercive powers over citizens and

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16 Susan Bambury, *op cit*.

17 Each issue of *The Free Radical* presents a collection of new horror stories and often some in-depth articles.

18 Frederick Bastiat, *The Law*, 1850. See p 14 in the translation by Dean Russell and published by the Foundation for Economic Education, Irvington-on-Hudson, New York, 1998.

should not be entered into lightly. The wholesale creation of new criminal offences in an effort to regulate behaviour often creates great problems in law enforcement and leads to community disrespect for the law. New Zealanders have failed to appreciate the limits on legal sanctions as a means of ordering society; moral purity cannot be brought about by legislation. Not only should we pass fewer laws, we should go through the statute book and see what can be cut out.[19]

The difficulty of such a task should not be underestimated. The rule of law can hardly be revitalised by passing more laws. Governments are unlikely to constrain themselves from passing bad laws when they are not politically rewarded for doing so. For example, they would be unlikely to create strong external parties, such as an empowered judiciary, that might defend the rule of law.[20] In addition, as Alexis de Tocqueville pointed out in 1835, when governments make people dependent on the state they are likely to make them more timid and less self-reliant. Timid, state-reliant people may fail to support civil institutions that would defend the rule of law.

In New Zealand, even the minimalist requirement the executive imposed on itself to produce regulatory impact statements that provide a public interest rationale for executive regulations has been reduced to a farce in cases such as the statement accompanying the Employment Relations Bill 2000.

The rule of law is virtually synonymous with constitutionalism. Governments that act constitutionally limit themselves to actions that accord with constitutional principles. They do not regulate arbitrarily in response to pressures and fads of the day. The rule of law is not the rule of the ruler. The rule of law constrains the ruler.

Walker, Hayek, Epstein and many others have developed principles that would help determine which regulations and laws clearly accord with, or violate, the principles that must underlie a rule of law.[21] Such principles could guide any review of regulations such as that envisaged by Palmer and Palmer – when and if the political will to conduct such a review arose.

A major suggestion, and a significant current legal and bureaucratic struggle, concerns the issue of requiring governments to compensate for regulatory takings.[22]

The separation of powers is also a fundamental constitutional principle. Any particular power can be constrained by creating a competing source of power whose possessor has the incentive to resist subsequent encroachment. Some ideas for reducing the ability of parliament to pass bad regulations are of this form.

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19 Palmer and Palmer, *op cit*, p 151.

20 Any abolition of the right of appeal to the Privy Council could well increase the influence of politicians over the judiciary, but even without that step there are ample grounds for concern that an activist judiciary would undermine rather than support the rule of law.

21 See, for example, Friedrich A Hayek, *The Constitution of Liberty*, 1960, University of Chicago Press; Walker, *op cit*; Richard Epstein, *Principles for a Free Society: Reconciling Individual Liberty with the Common Good*, 1998, Perseus Books; and Richard Epstein, *Towards a Regulatory Constitution*, New Zealand Business Roundtable, 2000.

22 For a thorough examination, see Richard Epstein, *Takings: Private Property and the Power of Eminent Domain*, Harvard University Press, 1985. For an example of a local legal battle, see *Westco Lagan Limited v Attorney General* CP142/00. For an example of the debate between business organisations and officials, see the New Zealand Business Roundtable's submission on the preliminary report of the Ministerial Advisory Committee: *Bio-what?* at: http://www.nzbr.org.nz/documents/submissions/submissions-2000/bio_what.doc.htm.

Democracy is a third critical constitutional principle. The mixed-member proportional electoral system (MMP) unquestionably gives disproportionate political power to a minority party that provides crucial votes in parliament to a dominant governing party. If New Zealand taxpayers are to repeat their unfortunate experiences with state-owned banks during the last 120 years, MMP will be the proximate cause. The decision to retain separate Maori seats notwithstanding the recommendation of a Royal Commission that they should go if MMP were adopted also appears to owe something to MMP.

Some ideas for inducing governments to act more constitutionally are democratic in nature. Options for greater use of direct democracy, such as referenda, take this form.

In total, there is no shortage of options for reform. Sifting through them is no easy matter. The utility of such an exercise depends on whether the public agrees that some constraints must be placed on government regulations. How are New Zealanders to be persuaded that there are *many* things about which it is better not to regulate?

The following comment by Johnston sums up the difficulties facing any strategy for confining parliaments to conform better with the rule of law:

> … the struggle for the rule of law is far too complicated a matter to be thought up and then put into practice. For it to be achieved and then maintained requires a contest that unfolds through generations. But for a contest to endure through generations, it must have roots deep in morality, in passion, in the subsoil of the community, out of which comes political activity.[23]

Concluding observations

Nothing that has been said implies that New Zealand stands out internationally for its regulatory excesses. To the contrary, New Zealand has achieved a high ranking in international indexes for economic freedom and for the quality of its regulatory environment. However, the current regulatory juggernaut is likely to reduce that ranking in time.

Concerns about regulatory costs are widespread in other countries, such as the United States, that share New Zealand's ranking for regulation. Indeed, most countries that are members of the OECD have attempted regulatory reform and the publications of that organisation provide an important data source on reform options and experiences. Australia and the United States stand out among these countries for their efforts at regulatory reform. Their experiences illustrate the difficulties confronting those who would seek to stem the regulatory juggernaut.

The OECD's explanation for regulatory excesses includes voter failure, partisan interest group behaviour, political decision making under majority rule, and bureaucratic behaviour. Commenting on the lack of coherent government strategies for reform, even when the need has become apparent, the OECD observed that:

> … in all these cases reform was delayed or blocked. Future use of regulation must be based on an understanding of why OECD countries have found themselves in need of reform, that is why governments have

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23 Paul Johnston, *The Tree of Liberty*, Blackstone Commentaries, No 2, The Locke Institute, 1998, p 31.

> found it difficult to control the quality and quantity of regulation and to take corrective action.[24]

Meanwhile, ill-considered, rushed, self-contradictory, and utopian regulations in New Zealand continue to destroy a few law-abiding people's lives emotionally and financially while confounding the hopes and aspirations of a multitude of others.

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[24] OECD (1997), *The OECD Report on Regulatory Reform: Synthesis*, OECD, Paris, p 14.

BIAA TELECOMMUNICATIONS CONFERENCE

MINISTERIAL INQUIRY INTO TELECOMMUNICATIONS

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13 NOVEMBER 2000

MINISTERIAL INQUIRY INTO TELECOMMUNICATIONS

1 Introduction and overview

This paper argues that a plausible case can be made that the recommendations of the Ministerial Inquiry into Telecommunications (the Inquiry) will lead to a more politicised and acrimonious industry with greater delays, higher costs, more rent-seeking activities and reduced investment in regulated infrastructure than is likely to occur under current arrangements.

Section 2 explains why the government's stated policy objective is likely to make it difficult to hold any regulator properly to account for decisions made in accordance with that objective.

Section 4 below evaluates the Inquiry's recommendations (summarised in section 3) in terms of those objectives. The key issue raised is the nature of the alternative against which those recommendations are being assessed.

Section 5 explores the question of the forgone alternative further by looking at the analysis in the Inquiry's report (the Report) of the problems with current arrangements. What problems with current arrangements need fixing? This section concludes that the problems appear to be so ill-analysed and ill-demonstrated as to make the case for regulation largely an article of faith.

Section 6 explains the need for a coherent theory of information and of regulation in any assessment of the likely efficacy of proposed regulations. There is an extensive economic literature on regulation.

Section 7 uses that literature to comment on the dangers of the regulatory path that is proposed for New Zealand and motivates this with observations on the experiences of other countries with industry-specific telecommunications regulators.

Section 8 makes some concluding comments, drawing attention *inter alia* to the need to consider compensation for regulatory takings if offshore investors are not to become even more wary about investing in infrastructure in New Zealand.

Perhaps two themes emerge from this paper: (1) governments should not attempt to fix things unless experts can prove something is broken relative to a realistic alternative; and (2) better analysis is required.

2 The government's policy objective

The government's stated policy objective is to achieve "cost-efficient, timely, and innovative services on an ongoing, fair and equitable basis to all existing and potential users".

This objective statement raises many questions:

- How is any regulator to determine what is cost-efficient, particularly when technologies are rapidly changing costs in unpredictable ways?
- What is fair and equitable? Is the principle that the user should pay more equitable than the principle that those on lower incomes or with fewer skills or who live in remoter areas should not get left behind even if they cannot pay the full cost?

- What if the most timely and innovative investments are uncommercial? Who should be made to pay the difference and what principle should be used to evaluate the equity of this impost? Moreover, if the difference between price and cost is subsidised, what is the incentive to reduce costs and to make production cost-efficient?

The government provided no criteria for determining what is fair and equitable, timely or innovative, or for making trade-offs between these attributes.[1]

One of the most important questions such an objective raises is: "who is to determine the trade-offs between these attributes and how are they to be held accountable for their decisions"?

It is well understood in management theory that accountability goes out the window if any agency or agent is asked to maximise in more than one dimension. When there is no basis for determining trade-offs, the choice is arbitrary. One decision is as good as another.

Such discretion confers the freedom to exercise arbitrary power. For example, an import licence can be granted in order to provide for a better deal for consumers or denied in order to protect jobs or foreign exchange. A risky workplace can be closed down for environmental or safety reasons or tolerated because of commercial realities. Which is it to be, who is to decide and on what basis?

3 The recommendations of the Ministerial Inquiry into Telecommunications[2]

The report of the Ministerial Inquiry into Telecommunications recommended the following new features of an institutional nature:

- a sector-specific commissioner, with a racial orientation;[3]
- an industry forum;
- new regulations based on specified and designated services;
- an indefinitely expandable interpretation of what constitutes the "ordinary telephone services" that Telecom is required to supply under the Kiwi share agreement in conjunction with rules designed to make it harder for Telecom to fund those additional services;[4] and
- the creation of a permanent body whose terms of reference would appear to make it an advocacy group for those who want subsidised access to services, including the disabled.

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1 This problem would be reduced if this objective were interpreted as being itself derived from the objective of economic efficiency. The efficiency criterion would then provide a yardstick for making trade-offs.

2 These are set out more fully in other papers to this conference.

3 Page 28 of the Report indicates that the commissioner would be required to have regard as far as practicable to any special factors that apply to Maori.

4 Interconnection prices would not include a contribution to Kiwi share losses. Telecom would not be able to charge Internet Service Providers ISPs for local calls to access the Internet. Telecom would not be permitted to change local calling areas without the regulator's permission. An offset is that Telecom would be permitted to lower residential line rentals in urban areas.

The Report proposes that various Telecom services be designated immediately on the grounds of claimed net annual benefits of $43 million.[5] It proposes a 31 July 2001 date for designating number administration and portability should agreement not be reached on these issues beforehand. Principles for determining prices would be imposed on designated services.

Specified services would initially include interconnection and carrier pre-selection, co-location on cellular sites, wholesaling and roaming of $2^1/_2$G cellular networks and Sky Television's conditional access systems.

An important facet of the proposed structure is that it would remove any burden of proof of the abuse of a dominant position in relation to the regulation of a designated service. The Report refers to this as '*ex ante*' regulation.

The report also recommends *inter alia* that the relevant government minister be given the power to require the re-sale of any parts of the radio spectrum that are not being used.

4 Evaluation of the Report's recommendations in the light of the government's objective

The Report provides (on page 7) a summary table that relates its recommendations to each component of the government's objective for the industry. The summary makes it clear that the Report is assuming that its regulatory structure will produce timely decisions that resolve disputes efficiently and result in efficient prices and efficient investment decisions.

The summary table, and the Report more generally, fail to specify carefully the alternative against which the recommendations are assessed. More specifically, it fails to demonstrate that the implicit alternative is the next best alternative or even a feasible alternative.

The summary table relies heavily on an alleged finding of $43 million per annum of net welfare benefits from its recommendations. The figure appears to be based on a calculated net benefit of $43.9 million per annum by the Centre for Research in Network Economics and Communications at the University of Auckland. The Centre's report (the CRNEC Report) is included in the Report as appendix 6.

A table in appendix 6 on page 69 provides a breakdown of the $43.9 million net gain. It shows that the estimated gain is virtually all derived from regulating inter connection prices down to 1.5 cents a minute. The details are provided on page 44.

Following criticisms of these calculations by the New Zealand Institute of Economic Research (NZIER) and the Networks Economic Consulting Group (NECG), CRNEC has reduced its estimate to between $20 and $40 million per annum.[6]

It appears therefore that the alternative against which the Report's recommendations are compared is that of a static world in which a monopolist can indefinitely derive an average interconnection revenue that is well above an assumed cost of interconnection of 1.5 cents per minute.

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5 This figure has subsequently been revised – see below.

6 John Small, *The Costs and Benefits of Telecommunications Regulation*, paper dated 6 November 2000 presented to this conference.

Putting aside all other points of dispute, the calculation assumes that:

- the New Zealand industry really has these characteristics; and
- there are no alternative remedies to the problem than those recommended.

The first question is about problem definition. Section 5 addresses this topic. The second question relates to the need to test proposals against relevant alternatives.

As it happens, there is an obvious alternative recommendation. The government could simply regulate interconnection prices down to 1.5 cents per minute and save all the costly complexities introduced by an industry commissioner, an industry forum, and specified and designated services. *The Report does not appear to consider this alternative.* It thereby fails to establish that its proposals are necessary.

The status quo is another alternative. While the Report does have this in mind, it is a very superficial treatment since it fails to discuss how the status quo would evolve in the absence of the regulatory apparatus that it recommends. For example, while it discusses the existence of the bill and keep agreement that Telecom has negotiated with Telstra Saturn[7] it is not apparent how it reconciles the existence of such contracts with the view it uses to justify the $43 million per annum figure cited in the Report. A fundamental problem here is the CRNEC report's reliance on the use of average revenue rather than the charge at the margin.

John Small's paper to this conference does acknowledge the information problem that underlies CRNEC's myopic approach to determining the counterfactual against which the Report's recommendations are evaluated. However, it fails to put this problem into the broader context of a theory of information that relates to the problems of central planning.

The issue that needed to be addressed, and was not, was how the regulatory apparatus that the Report proposes is likely to work out and evolve in practice given all the problems with the theory of monopoly in relation to innovation and the problems of information and incentives that will bedevil any industry-specific regulator.

I suggest that this failure to assess alternatives carefully and to establish the superiority of its recommendations against realistic alternatives is one of the Report's major weaknesses.

5 Problem definition

At the heart of the alleged welfare gains from the Report's recommendations is the assertion on page 45 of appendix 6 that:

> The local loop for the vast majority of New Zealanders is an essential facility operated by a monopolist under naturally monopolistic conditions.[51] This means that replicating the local loop in order to provide wholesale services is uneconomic and socially wasteful.

Footnote 51 asserts that the existing network is a natural monopoly if it would be socially wasteful to construct an entirely new network to supply all Public Switched Telephone Network (PSTN) connections offered by Telecom and no others. It further asserts that Saturn's investments do not contradict the natural monopoly contention

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7 Refer to pages 66–67 and appendix 6, pp 30–31.

since Saturn's networks provide a large and more valuable set of services than those available from copper wire.

I find it difficult to look at this statement other than with incredulity for the following reasons:

- it overlooks the reality that Telecom's current market share was at its peak when the old New Zealand Post Office enjoyed a statutory monopoly; it is competition that is eroding that market share and shows every sign of continuing to do so;
- the concept that there is no price discipline unless Saturn replicates the network for the supply of all PSTN connections ignores the issue of competition at the margin, contestability and credible threats;
- the argument that there is no product market competition because Saturn is providing additional services seems to be akin to arguing that because electricity provided a larger and more valuable set of services than gas, electric light would not be able to compete with the gas light;
- the statement omits any reference to wireless competition in all its forms; and
- it fails to acknowledge even the existence of a substantial body of expert opinion to the contrary, let alone respond to it.[8]

The discussion in the main body of the Report is equally perplexing. Section 3.7.1 purports to be an assessment of the existing regulatory regime. The discussion is superficial, but to its credit it is also inconclusive. But this inconclusive finding makes the Report's case for rejecting the existing regime something of a mystery.

The Report puts great emphasis on the assertion that New Zealand's arrangements are suspect by virtue of their uniqueness in an international context. However, it fails to show that there is any country whose approach is not unique. In comparing the approaches of Australia, New Zealand, Chile and Guatemala, Pablo Spiller and Carlo Cardillo found that each had blazed its own trail and experienced its own difficulties. For example, they commented that the Australian approach concentrates decision making in one set of hands and gives parties the (wrong) incentive to make exaggerated and continuous claims in the hope of extracting favourable treatment.[9]

In any case, the Report's unquestioned presumption that the existence of regulation internationally proves that it serves the national interest has been disproved by an extensive literature on the economics of regulation.[10] The demand for self-serving regulations is insatiable. Supply is determined by political considerations. The

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8 Refer, for example, to the views of Gary Becker, Richard Posner, Pablo Spiller and Carlo Cardillo, Lawrence Gasman and Dan Alger. John Kay, writing in the *Financial Times* as recently as 17 October 2000 on the failures of regulation, stated bluntly that: "Competitive answers are usually better. This is straightforward enough for telecommunications, where the days of natural monopoly are over".

9 Pablo Spiller and Carlo Cardillo, 'The Frontier of Telecommunications Deregulation: Small Countries Leading the Pack', chapter 3 in *Regulator's Revenge: The Future of Telecommunications Deregulation*, Tom Bell and Solveig Singleton (eds), Cato Institute, 1998.

10 See pages 326–327 in Kip Viscusi, John Vernon and Joseph Harrington, *Economics of Regulation and Antitrust*, MIT Press, 1998.

national interest is not necessarily the dominant consideration in any particular decision.

Regulations commonly create cross-subsidies that have to be preserved by entry barriers that the regulations protect. Vested interests in the form of user groups and firms in the industry will therefore lobby for regulations. The willingness of firms to lobby for regulations undermines the argument that regulations tend to benefit consumers, not firms.

In the absence of regulation of interconnection, for example, any substantial firm that wanted Telecom to lower its interconnection prices could achieve this goal by making Telecom or its shareholders an offer that was too good to refuse. The fact that they do not do so surely establishes that they are putting their shareholders' interests ahead of consumers' interests. While I would be amongst the last to criticise them for this, it simply makes the point that businesses that are lobbying for regulation are likely to be doing so primarily because it serves their shareholders' interests.

The Report asserts on page 2 that New Zealand is unique in not having industry-specific regulation, yet how else should the Kiwi share be interpreted? Moreover, on page 16, footnote 8, the Report observes that three other OECD countries do not have an independent telecommunications regulator.

In assessing New Zealand's current arrangements in section 3.7.1, the Report also mentions the time it took Telecom/Clear to achieve the first interconnection agreement and the time taken to achieve number portability. It asserts that existing arrangements have proven inadequate to resolve disputes quickly and effectively.

This discussion lacks any framework for analysis. In contrast, a property rights framework would immediately ask if a lack of clarity concerning property rights could explain the problem. Clearly antitrust legislation creates uncertainty as to the legality of a dominant incumbent's offer in a commercial negotiation. Both the dominant incumbent and a new entrant are required to get the best deal they can negotiate for their shareholders. Antitrust legislation gives the new entrant negotiating leverage. If it takes a commercial dispute under this legislation to the court or regulator it can hope to get a better deal and can expect to do no worse. This bias is not mentioned in the Report.

Such an analysis should have led the Report to conclude that difficulties in negotiating agreements are intrinsic to all antitrust legislation. Whereas voluntary exchanges proceed on the basis of mutual advantage, mandatory exchanges create the likelihood of loss, acrimony, refusal to cooperate and litigation.

Lacking any framework, the Report leaps instead to the conclusion that antitrust legislation is more desirable if it resolves disputes quickly. In the last paragraph in this section it equates speed with efficiency and relates delay to the degree of contentiousness. However, disputes could be determined very quickly by the throw of a dice or by other arbitration processes. There is no need for the apparatus of an industry-specific regulator and industry forum if speed is all that is required. In reality, a speedy decision is not necessarily a sound decision, nor would it necessarily be less contentious.

Moreover, both the Telecom/Clear case and the number portability case had a path-breaking characteristic that the Report does not mention. Because of the lack of clarity of property rights they both presented major problems.

Having put great emphasis on speed, section 3.7.1 fails to produce any evidence that negotiations over New Zealand's subsequent interconnection agreements are currently proving to be more troublesome or prolonged than those emanating from regimes with an industry-specific regulator. The Report gives the impression that the Australian arrangements are comparable with New Zealand's in relation to cost and time.

However, Dr Tony Warren of Networks Economic Consulting Group has commented that the Australian regime is "drowning" in disputes over access, reporting that "at last count, there were 20 ongoing access disputes before the commission, many of which do not even involve Telstra".[11] A publication by Telecom this year states that Australia has had 37 arbitrations in recent years and that 30 of them are still ongoing.[12, 13]

Perhaps the weakest aspect of the problem definition section of the Report is its failure to consider, other than in the most superficial way, how New Zealand has fared compared with the experience of other countries with different regimes. The minister of communications has indicated to this conference the government's desire to see New Zealand lead the world in the uptake of new telecommunications and information technologies. Yet research by the Institute for the Study of Competition and Regulation (ISCR) has found that, under the current regime, New Zealand is at the forefront, in terms of uptake, on all surveyed measures bar one.[14]

Although the Report does not appear to cite such analyses, the chairman of the Inquiry acknowledged at this conference that there is plenty of evidence that New Zealand has done relatively well. In the next breath, however, he asserted that the Report was making a judgment about the future.

Yet, as already noted, John Small's paper to this conference has eloquently explained why experts cannot predict how the future will evolve under the status quo. We can also note that the Report provides no *realpolitik* analysis of how regulation is likely to evolve under its proposals.

In short, this debate over the problem definition section of the Report appears to have got perilously close to the point where we must conclude that the efficacy of the extra regulations that it proposes are an article of faith. The future under the status quo cannot be predicted yet its advocates believe it will be worse than that under an industry-specific regulator.

This key problem here is the lack of an adequate theory of information, and therefore of regulation.

6 The lack of a theory of regulation

The Report contains no recognisable in-depth discussion of the information and incentive problems that arise under the type of regulation it is recommending.

Nor is there any recognisable analysis using public choice theory of how special interest groups might be able to exploit the proposed arrangements. The opportunities

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11 *The Press*, 18 July 2000.

12 Telecom, *Springboard to Success*, p 28.

13 The Inquiry report on page 24 also notes the costs of the Australian regime.

14 The exception is the number of secure ISP servers, but there are reasons why the United States might have an advantage in this area and it would be a challenge to make a case that the welfare of New Zealand consumers can be assessed by counting the number of ISP servers in New Zealand.

the proposed forum and the disclosure requirements provide for collusion and capture are unexplored.

These glaring gaps are compounded by the absence of any recognisable comparative institutional analysis. It is not that the Report is profoundly unaware of all these difficulties and omissions. They lurk in its nooks and crannies, emerging from time to time to justify one decision rather than another, only to be ignored entirely in other places.

The discussion on pages 26–27 of the Report on regulatory creep illustrates their influence. Perhaps the Report's most promising proposal for guarding against regulatory creep is the recommendation for a sunset clause in the form of a review after six years. While such a clause is to be strongly commended, its existence creates some perverse incentives that are not noted in the Report. In particular, it creates an incentive for the commissioner to confer privileges on incumbents and politically influential classes of consumers at an earlier stage than might otherwise occur. The commissioner could then rely on these groups to argue for the preservation of the commissioner's office.

The puzzle about the absence of any sophisticated comparative analysis of the strengths and weaknesses of regulatory regimes in the Report is heightened by the fact that this approach was used intensively in the second half of the 1980s when New Zealand governments adopted the lighter-handed structure.

These remarks can be illustrated using the summary table on page 7 of the Report and the discussion in paragraphs 6, 12 and 13 of the CRNEC Report. The summary table simply assumes that the regulatory structure will achieve efficient prices. The CRNEC Report implicitly makes the same assumption by commenting in paragraph 6 that "carefully designed regulation is capable of promoting efficiency gains". Its failure to address the question of how regulation is likely to work out in practice given the problems of incentives and information that bedevil the *realpolitik* of regulation raises major questions. None of these problems is discussed under the heading of 'Costs of Regulation' on page 7 of the CRNEC report. Paragraph 13 simply assumes the existence of "… a well organised and well governed regulator [who] makes all decisions with care …".

(As an aside, the argument in paragraph 13 that the costs of regulatory errors will be zero if the decisions are unbiased seems to be an error. Take the case of the regulator who regulates the interconnection price down to 1.5 cents per minute. If that price is below marginal cost there is a theoretical positive welfare loss to society. But the same applies if the price is above marginal cost. The *ex ante* expected value of two positive numbers is obviously itself positive, not zero.)

7 Implications for the government's objectives

Direct regulation of prices must lead to regulation of quality.

A major danger with all price regulation is that it will lead to cost-plus behaviour with endless litigation over costs. Because price regulation has to have regard to costs it has to have regard to the cost of capital – that is, rates of return.

But rate of return regulation biases investment decisions. In particular, it is all too likely to give investors the impression that losses will fall with them while prices will be regulated down to remove any profits above the cost of capital.

Moreover, the effects will not be confined to those investing in currently designated services. All investors must consider what services might be designated in future.

These considerations make it unlikely that the proposed structure will lead to efficient prices or investment in infrastructure. The Report seems to be simply naïve in its lack of consideration of the *realpolitik* of regulation.

The Report, perhaps understandably, appears to interpret the government's objectives as requiring it to find a structure that permits cross-subsidies for privileged groups of users. However, this is likely to require the commissioner to find ways of forcing incumbents to fund these cross-subsidies. Realistically, this will have to be at the expense of other users. But this will simply induce competitors to use new technologies to 'cream-skim' the incumbents. The regulator will then be caught between a rock and a hard place. The political pressures to erect entry barriers to protect the incumbents are likely to be very strong. This could be done under such guises as 'preventing uneconomic duplication of services', 'guarding against first mover advantages', 'preventing predatory pricing or dumping', or 'stopping fly-by-night competition'. None of this is adequately discussed in the Report.

What about the government's objective for timely and innovative services? The Report's relevant recommendations, as summarised on page 7, are clearly based on the hope that an industry-specific regulator and the industry forum will make timely and efficient decisions. If only.

- Dr Justus Haucap has reported from Germany that industry-specific regulation in Europe "is rapidly earning a reputation for preventing or delaying the introduction of price reductions and new services".[15] He observes that:
  - Deutsche Telekom was denied a price reduction for some international toll calls in October 1999 by a German regulator on the grounds that they would harm competitors;
  - France Telecom's regulator had reserved the right to refuse to allow it to invest in ADSL because it might obtain a 'first mover' advantage;
  - British Telecom's regulator objected to its proposal in December 1999 for a flat rate option for Internet access on the grounds that the proposal might be anti-competitive; and
  - early this year the European Commission issued a warning to incumbent telecommunication companies in Germany, Spain and Italy because it deemed their monthly line rentals were too low.
- A study cited by the NZIER estimated that $1.27 billion a year is lost in Australia from regulatory delays in introducing voice messaging and up to $50 billion in delays in the allocation of cellular phone frequencies.[16]
- Dr Warren has also expressed the view that Australia is not seeing competition for copper wire because of the low prices the Australian regulator is setting for copper wire.

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15 *National Business Review*, 14 July 2000.

16 Telecom, *Springboard to Success*, op cit, p 28.

- Vodafone told the Inquiry that its proposed approach was likely to impede the adoption of new technology in New Zealand.[17]

8 Concluding comment

The case for heavier, industry-specific regulation of telecommunications is much weaker today than it was in the late 1980s when the relative merits of alternative regulatory regimes were intensively analysed. The competitive pressures on Telecom that were then largely anticipated are now manifest.

No regulatory regime is ever likely to be wholly satisfactory, but the choice between them cannot be made properly by focusing on the weaknesses of one regime and contrasting them with a regime that effectively assumes a perfect regulator. The Report seems to illustrate amply the wisdom of the following assessment by *The Economist*:

> The biggest economic-policy mistake of the past 50 years, in rich and poor countries alike, has been and still is to expect too much of government. Statism has always found all the support it needs among mainstream economists. They are unfailingly quick to point out various species of market failure: they are usually much slower to ask whether the supposed remedy of government intervention might not, in practice, be worse.[18]

The Report's proposals for '*ex ante*' regulation allow an incumbent to be regulated without rigorous proof of wrongdoing. Appendix 6 of the Report raises the issue of an essential facility. Where a private owner has a facility that must be taken in the public interest there is a tradition going back to Magna Carta and beyond that due compensation be paid to the rightful owner. The Public Works Act 1960 was most emphatic in this regard, but the principle is found in several other important pieces of legislation. Oregon voters have just passed a measure called Measure 7 that requires payment to land owners when Oregon regulations cause property values to decline.

Telecom was sold subject to rules that permitted it to compete aggressively, but not to abuse a dominant position. Proof of abuse had to be given subject to due process. To change the rules after that sale and to propose an 'evolutionary' approach to redefining the coverage of the Kiwi share is arguably a partial confiscation of Telecom's property rights. Furthermore, there is evidence that Telecom's share price has declined relative to Telstra's share price during the period of the Inquiry. It is puzzling that the Report did not discuss the issue of compensation for regulatory takings in assessing the possible implications of its regulatory proposals for dynamic efficiency.

Policy analysts will note two paradoxes. One is that public policy is seemingly so concerned about the issue of monopoly in this very competitive industry when it is so unconcerned about monopoly in such areas as health, education, accident compensation, trade unions and producer boards. A second is the ease with which governments can be simultaneously concerned to regulate against collusion by business and to regulate for industry consultation and coordination. Does the left hand know what the right hand is doing? The following words by Adam Smith seem as apt today as when first written:

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17 Paragraph 3.4.8, page 23. See also paras 3.2.2 to 3.2.4 of the Report.

18 'The puzzling failure of economics', *The Economist*, 23 August 1997, p 13.

> People of the same trade seldom meet together, even for merriment or diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.[19]

Lest economists and businesses feel that they are being unfairly singled out by this accusation, I hasten to add Adam Smith's opinion of those who would regulate private affairs:

> The statesman, who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could be safely trusted, not only to no single person, but to no council or senate whatever, and which would no-where be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it.[20]

In conclusion, a plausible case can be made that the Report's proposals will lead to a more politicised and acrimonious industry with greater delays, higher costs, more rent-seeking and reduced investment in regulated infrastructure than is likely to occur under current arrangements.

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19 Adam Smith, *Wealth of Nations*, 1776, Book 1, Chapter 10, pt 2.

20 Adam Smith, *Wealth of Nations*, 1776, Vol 1, Book 4, 'Of systems of political economy', Chapter 2.

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE INSIDER TRADING DISCUSSION DOCUMENT

OCTOBER 2000

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 (the Act) 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.

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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.

2 Policy objective

2.1 The ministry's covering letter of 5 September 2000 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 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 Act. 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.

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3 *New Zealand Herald*, 28 September 2000.

4 Carlton and Fischel, *Standford Law Review*, *op cit*, p 860.

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 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 who are accustomed to highly intrusive regimes and 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 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 problem with the New Zealand market. However, a local professional fund manager did say that he knew of some investors in the United States who were worried about the possibility of unreported trading by New Zealand directors. Presumably boards would change their rules about trading by directors were these concerns sufficiently important.

3.6 Another possible source of concern stems from academic research that typically finds that share prices 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

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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 or did not appear to have a clear view on whether the problems arose from weaknesses in the legislation or in its enforcement.

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 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 putting forward the current proposals have failed to do either.

3.9 Both the 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 NZBR 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, taking the existing framework as given. The minister's reported comments implicitly acknowledge that the regime might itself be fundamentally at fault, but 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 appear to preclude potentially all trading since 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 (for example, 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 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.

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 at large.[9] Adopting Australian regulations implies adopting the 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.

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

7 Epstein, *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*, 7–8 October 2000, considers only such benefits, ignoring entirely the costs of forced disclosure rules.

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.

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 of Economic Development 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 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 markets, profits or even capitalism adequately 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.

EDUCATION AND THE LABOUR MARKET

STOKES VALLEY ROTARY CLUB

EDUCATION AND ECONOMIC GROWTH

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

WELLINGTON
10 JULY 2001

EDUCATION AND ECONOMIC GROWTH

Economic growth

I want to begin this talk with a discussion of economic growth. In particular, I will discuss developments in the theory of economic growth, the role that education plays in generating economic growth and the implications for education policy. This issue is extremely topical. New Zealand's long-term growth performance has been poor. Between 1960 and 1997, growth in real gross domestic product (GDP) per capita in New Zealand was less-than-half the average for all Organisation for Economic Cooperation and Development (OECD) countries. Although our growth performance improved for several years during the 1990s, policy slippage and reversals since that time have seen it become mediocre again. The upcoming Knowledge Wave conference will provide a forum for discussing ways of closing the gaps between New Zealand and more successful countries.

Economists since Adam Smith and David Ricardo have been interested in the issue of economic growth and its causes. It was not until the 1950s and 1960s, however, that the first theories of economic growth were formalised. These early models, known as the neoclassical approach to growth theory, had a number of weaknesses. One of the key ones was that they assumed that technological change (and hence productivity growth) was driven entirely by factors beyond our control. In economic jargon, technological change and productivity growth were assumed to be exogenously determined. The actions of consumers, firms and governments had no impact on the long-run growth rate of the economy.

Clearly these models did not provide a good representation of the real world. Beginning in the 1980s, a series of more sophisticated models appeared based on so-called New Growth theories. These models are not uniform. One strand emphasises the stock of human capital as an important determinant of economic growth. A second strand places more emphasis on the incentives that firms have to generate new ideas. Without going into technical detail, a couple of points are worth noting up front:

- first, they specifically recognise that the growth rate of the economy is not driven solely by outside factors; and
- second, they show that government policies have an important role to play in determining the long-run growth rate of a country's economy.

These models are clearly more realistic in their portrayal of the economy with consumers, firms and governments all having an impact. They also provide a much more useful benchmark for thinking about the role of education in economic growth and the design of education policies.

In these recent models, unlike their earlier cousins, education is seen as contributing to economic growth in two ways:

- it directly affects economic growth by making individual workers more productive; and
- it indirectly affects economic growth by leading to the creation of knowledge, ideas and technological innovation – either through the process of acquiring education itself or because education is a key input into the development of a research sector that produces new knowledge and ideas.

It needs to be stressed that, under this approach, education is important not only because educated people engage in university research. The United States is a world leader in many fields of research yet only about a quarter of its labour force has a university degree. Education is also important because it generates new ideas in the private sector. Knowledge creation is not a monopoly of either the public or private sectors.

A number of studies have confirmed the importance of education in explaining growth. The consensus view on the direct effects of education is that the private rate of return to an individual from an additional year of schooling is anywhere from five to 15 percent. This must, to some extent, reflect the fact that employers see educated workers as more productive. Similarly, studies find that increases in educational attainment account for around 20 percent of growth in output per worker. Education also has indirect effects and studies have shown that higher levels of human capital are associated with significantly larger physical investments, higher rates of technology transfer and longer life expectancy. Much remains to be done in measuring the exact impact of education on economic growth. Nonetheless, the OECD noted recently that:

> … the improvement in human capital seems to be a common factor behind growth in recent decades in all OECD countries, especially Greece, Ireland, Italy and Spain, where the increase in human capital accounted for more than half an extra percentage point of growth in the 1990s compared with the previous decade.[1]

These New Growth models have a number of other policy implications. One of them is that the quality of education matters. Much of the focus in recent years in developed countries has been on improving access to secondary and tertiary education. But access to education – simply increasing school enrolments – is not enough. Labour force quality, as measured by the performance of students in international comparative tests, has been shown to have a strong impact on economic growth. This has significant implications for curriculum design, as well as teacher and school performance.

The quality of government spending also matters. We often hear calls for more spending on research and development (R&D). But economic growth depends on the quality of resources committed to R&D, not just on the dollars spent. Poor investments of public funding – whether badly targeted spending or tax breaks – that do not increase the quality and quantity of R&D activity will do nothing to increase economic growth.

While education can play a role in fostering economic growth, we have to be realistic about its potential. Education should not be seen as a silver bullet that will cure all economic ills. The former Soviet Union was strong on education, particularly of scientists and engineers, yet we now know it was a basket-case economy. As Stephen Parente of the University of Illinois commented recently, "education spending cannot explain economic miracles. Japan did not double its schooling capital when it doubled its income".[2]

The wider policy and investment environment is equally critical for sustained economic growth. New Zealand's policy framework must provide good incentives for

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1 OECD (2001), *Education at a Glance*, OECD Indicators, 2001 edition, Paris, p 49.

2 Stephen L Parente, quoted in Virginia Postrel, 'Economic Scene: Wealth Depends on How Open Nations are to Trade', *New York Times*, 17 May 2001, http://www.nytimes.com.

the generation of ideas and knowledge and the diffusion of technology. This includes the need for:

- strong intellectual property rights that encourage the generation, creation and implementation of ideas and innovations;
- an immigration policy focused on attracting skilled and enterprising workers; and
- outwardly oriented trade and investment policies that facilitate the transfer of knowledge and capital across international boundaries. The OECD estimates that trade liberalisation alone added up to two-thirds of a percentage point to annual growth during the 1990s – more than the contribution from education.

We need only look at fast-growing countries such as Ireland and Finland to see that a pro-growth investment climate is crucial to creating a knowledge economy. The success of Ireland's economy since the mid-1990s has been attributed to a convergence of many factors. Fundamentally, Ireland has pursued a programme of market-based reforms and has moved from being an interventionist economy to one that is among the freest in the world. Critical success factors include a large fall in the ratio of government spending to GDP, low taxes (especially on capital income), the outward orientation of trade and investment policies, an active programme of deregulation, privatisation of government enterprises, a business-friendly environment, rising labour force growth and an increasingly skilled workforce. Education alone has not transformed the Irish economy. In the case of Finland, the IMF noted that "sound macroeconomic policies and growing economic openness have been at the root of Finland's remarkable recovery from the recession of the early 1990s".[3] Both Finland and Ireland are ranked well ahead of New Zealand in the 2001 World Competitiveness Survey – third and seventh respectively versus New Zealand's twenty-first ranking.

We also need to be realistic about the time required for education policy change to deliver gains. While education can influence growth, it will not do so quickly. Policy changes aimed at increasing the generation of knowledge and ideas may take years to show a dividend. It is therefore important that governments adopt a long-term focus to policy making.

Does more spending improve education outcomes?

The education–growth relationship is a two-way street. While education matters for growth, the reverse is also true. If New Zealanders want more resourcing – both public and private – of education, we need a growing economy to pay for it. It is idle for commentators to bemoan the 'low' levels of resourcing of schools and tertiary institutions in New Zealand relative to countries such as Australia, Canada or the United States. They spend more on education because they can afford to spend more. It is not a question of New Zealand governments being frugal in the area of education spending. Indeed, the opposite is true. A recent OECD report showed that New Zealand's public expenditure on education relative to GDP was above the OECD average and indeed fifth highest among 28 countries.[4] It also pointed out that between 1995 and 1998:

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3 International Monetary Fund, Finland–2001 Article IV Consultation, 7–18 June 2001, http://www.imf.org/external/np/ms/2001/061801.htm.

4 OECD (2001), *op cit*, p 71.

- expenditure on educational institutions as a percentage of GDP rose from 4.9 percent to 6.1 percent in New Zealand;
- expenditure on education at all levels grew at a rate that was six times faster than the growth in GDP. New Zealand was one of only six OECD countries where education spending increased faster than GDP; and
- much of this increase was (rightly) concentrated on the primary and secondary education sectors.[5]

But have we been getting value for money for this additional spending? On its own, more spending will not necessarily deliver better educational achievement. There is a growing literature on the issue of school resourcing and education achievement. Eric Hanushek of the University of Rochester has conducted a number of studies in the United States and has found that there is little or no relationship between higher spending and educational achievement. In a 1999 report commissioned by the US Department of Education, the National Research Council concluded that:

> … additional funding for education will not automatically and necessarily generate student achievement and in the past has not, in fact, generally led to higher achievement.[6]

There is no better illustration of this than the experience of Kansas City. To improve education for black students and encourage desegregation, the Kansas City School District undertook a 'cost-is-no-object' educational reform. The school district spent up to US$11,700 per student – more money per student, adjusted for the cost of living, than any other of the 280 largest school districts in the country. The money bought, among other things, higher teachers' salaries, new schools and a student : teacher ratio of 12 or 13 to one, the lowest of any major school district in the country. In a 1998 article, Paul Ciotti discussed the results of this initiative:

> The results were dismal. Test scores did not rise; the black-white gap did not diminish; and there was less, not greater, integration. The Kansas City experiment suggests that, indeed, educational problems cannot be solved by throwing money at them, that the structural problems of our current educational system are far more important than a lack of material resources, and that the focus on desegregation diverted attention from the real problem, low achievement.[7]

Clearly, there is more to creating a successful education system than more money. We need to debate wider issues, rather than focusing simply on the issue of funding.

Recent education policy directions

For at least 10 years, New Zealand education policy was generally on the right track. From the time of *Tomorrow's Schools* and *Learning for Life* in the late 1980s, progress was being made on a number of key policy fronts:

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5 OECD (2001), *op cit*, pp 73–75.

6 Helen F Ladd and Janet S Hansen, eds (1999) *Making Money Matter: Financing America's Schools*, National Academy Press, Washington DC, http://www.nap.edu/books/0309065283/html.

7 Ciotti, Paul (1998), *Money and School Performance: Lessons from the Kansas City Desegregation Experiment*, Cato Policy Analysis, No 298, Washington DC, March 16.

- schools and tertiary institutions were becoming more self-managing;
- choice was increasing and education funding policies were becoming more demand-driven,
- funding and regulatory policies were generally becoming more neutral – with public and private providers treated in a more even-handed way; and
- government resources were being targeted more effectively toward lower levels of education and toward those for whom socio-economic status represented a barrier to educational access and full participation in society.

Some of the policies introduced by successive governments were very much in line with international thinking – the student loan scheme, deregulation of tuition fees, bulk-funding of schools, Targeted Funding for Educational Achievement, the Targeted Individual Entitlement (TIE) scheme and self-management in state schools, to name only a few. Many of us would like to have seen the reform process move further and faster – much more needs to be done to break down the public education monopoly and to refocus on core subjects and rigour in the curriculum. Regrettably, the period since late 1999 has seen policy backsliding. For example:

- bulk-funding was eliminated, although more flexibility has been introduced for all schools;
- the TIE scheme was cut;
- a version of zoning was re-introduced;
- private school funding was capped; and
- the student loans scheme was made more concessional, increasing its regressive nature.

It is important to point out that the changes since 1999 were not made in response to identified shortcomings in policies. Quite the opposite – what research exists on the TIE scheme, bulk-funding and student loans is positive. More importantly, these programmes seemed to working well on the ground. Recent reforms, by and large, seem to have been politically motivated.

One prominent issue over the past year has been the 'closing the gaps' policy. Progress on improving education achievement among Maori is urgently required. However, it is ironic that the government has implemented policies such as the re-introduction of zoning and the abolition of the TIE scheme that will deny educational opportunities to the disadvantaged. At the same time there has been a marked change in the government's spending strategy. Whereas previous governments have focused discretionary spending on the school sector, the recent focus has been on the tertiary sector – through increased subsidies to tertiary institutions and changes to the student loan scheme. The case for government funding is much stronger for the earlier stages of education than for the tertiary level. In recent years public spending on tertiary education in Australia and Canada has been significantly cut back, and there have also been actual reductions in Britain, Germany and Denmark. Requiring higher private contributions to tertiary education – mostly in the form of student fees – has been the OECD norm.

Choice and competition in the education sector

The general direction of education policy in New Zealand now places less emphasis on choice and competition between public and private institutions. At the school level, this is reflected in the zoning changes and the capping of private school funding. At the tertiary level, the second Tertiary Education Advisory Committee (TEAC) report is openly hostile to the notion of choice and competition as a means of allocating resources. What was once seen as choice is now seen as duplication. What was once seen as diversity is now seen as fragmentation. Competition has been replaced by cooperation as a guiding principle.

This change in direction comes despite considerable evidence of the benefits of competition – in education as well as in other sectors. For example, there is a growing body of evidence that highlights the gains from competition in education at both the school and tertiary education levels. According to a number of studies, competition leads to:

- increased educational achievement per dollar spent (that is, more productive spending);
- increased educational attainment, graduation rates, test scores and graduate wages;
- increased teacher quality, particularly for schools serving predominantly lower income students; and
- enhanced student test scores.

One American analyst, who has written widely on school competition issues, has summarised the evidence on competition as follows:

> Most of the work on government responses to competition has focused on the market for education, and here the literature is strikingly consistent – competition improves public schools …[8]

New Zealand's experience with competition at the school level, though often criticised, has been favourable. The broadly 'market-based' New Zealand reforms have led to increased diversity of supply and choice for parents and children, especially those from low socio-economic groups, Maori and Pacific Islands people. This has included the development of Kura Kaupapa Maori, new forms of education such as Alternative Education and the development of Special Character schools.

International policy directions

In moving away from choice and competition, New Zealand is swimming against an international tide. The trend toward choice, competition and private education – in all their guises – continues unabated in other jurisdictions:

- school choice in the United States continues to gather pace, despite the voucher setbacks in last year's election ballot initiatives and the failure to include a voucher initiative in the Bush education bill;

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[8] Taylor, Lori L (2000), 'The Evidence on Government Competition', *Economic and Financial Review*, Second Quarter 2000, Federal Reserve Bank of Dallas, Dallas, p 7.

- private management of public schools is expanding rapidly. Edison Schools, one of the leading school management firms, now has 113 schools in 45 cities with 57,000 students. The New Zealand Business Roundtable is bringing the chief executive of Edison Schools, Benno Schmidt, to New Zealand later this year to deliver the annual Sir Ronald Trotter Lecture;
- Indiana has become the thirty-eighth US state to pass legislation allowing charter schools. There are now more than 2,000 charter schools in the United States serving over 500,000 students;
- increasing use is being made of tax credits as a means of financing private education. Tuition tax credit bills have been introduced in 10 states;
- Robert Reich, a former Labor Secretary in the Clinton cabinet who was brought to New Zealand by the Labour Party in 1998, has proposed a progressive voucher scheme pegged to family income;
- the New Democrats, who represent the Clinton wing of the Democratic Party, have come out in support of charter districts – where education boards contract out management of whole school districts; and
- Florida has vastly expanded educational opportunities for students with disabilities, with 340,000 students now able to obtain a voucher to attend any public, private or parochial school.

The trend towards choice, competition and public/private partnerships is not limited to the United States. In the United Kingdom, the Labour government under Tony Blair has contracted out management of individual schools and Local Education Authorities to private firms. Its recent election manifesto promised more of the same. In addition, the Private Finance Initiative in Britain is providing access to capital to upgrade schools, tertiary institutions and hospitals. In Australia, the New South Wales Labor government is reportedly looking at options for increasing private participation in the construction and financing of public schools. In Ontario, the government of premier Mike Harris has foreshadowed the removal of the province's strict school zoning laws and introduced a tax credit for parents with children in private schools.

These changes have nothing to do with ideology. Indeed, they come from governments of varying political stripes. They are simply a pragmatic and practical response to identified policy problems. There is no reason why those involved in the education sector – whether teachers, principals or support staff – should resist such moves. By the time the bulk-funding experience had ended, more than 40 percent of teachers were in bulk-funded schools. By and large, principals and teachers supported the greater freedoms and better environment afforded by bulk-funding and greater self-management generally. Schools were using additional resourcing and flexibility to make life better for teachers and students – whether through the employment of additional teachers, additional teaching support staff to free up teachers to focus on curriculum issues, or an increase in teacher professional development budgets. Teachers have everything to gain from moves away from a government monopoly system with the rigid and unrewarding pay scales, bureaucratic paperwork and educational fads and fashions associated with it.

Conclusion

I have perhaps come at my topic in a sideways fashion – by talking about education's role in generating economic growth and the implications for government education policy. This was intentional. The education system today has a big job to do. And it is not an easy one. Schools, students and families face many pressures – social, demographic, economic and technological. As the minister of education said recently in a speech to the School Trustees Association Conference:

> Today's children need to be far better prepared than our own generations: with creative, critical thinking and problem solving skills; with strong literacy and numeracy skills that allow them to be effective users and creators of information; with competence in technology; and with a desire to continue lifelong learning.[9]

Good education and labour market outcomes will depend as much on the wider policy framework as on the education policy framework we design. The Knowledge Wave conference could provide us with a rallying point for bringing together disparate views on education policy design. In designing education policy, the issue is not government or no government, right wing or left wing, centralisation or decentralisation. The issue is which mix of policies best advances the country's economic and social goals. Systematically approaching policy development from that angle would serve us well as a nation and benefit all New Zealanders.

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9 Mallard, Trevor (2001), speech to School Trustees Association Conference, Invercargill, 6 July.

ARTICLE BY RALPH NORRIS FOR THE
NEW ZEALAND HERALD

FULL EMPLOYMENT IS ABOUT SOUND LABOUR MARKET AND WELFARE POLICIES

NOVEMBER 2000

FULL EMPLOYMENT IS ABOUT SOUND LABOUR MARKET AND WELFARE POLICIES

To date *The Jobs Challenge* series has concentrated on industry development and by implication growth in incomes and the economy. While these are important goals, they involve quite different issues from the goal of achieving full employment. Therefore it is necessary to identify the relationships between employment, industry development, productivity and incomes.

This is easy to demonstrate. An economy can achieve full employment at any level of average (per capita) income. Hong Kong maintained more or less full employment from the 1970s up to the recent Asian crisis yet its average incomes rose several fold in that time.

Nor is employment necessarily related to economic growth. The US and European economies grew at comparable rates following the early 1980s recession but whereas the United States created some 18 million new jobs in the 1980s Europe added no net jobs in that period.

Per capita incomes and growth in incomes are essentially about levels of productivity and productivity growth. Employment on the other hand is about matching labour costs to productivity and ensuring there are incentives to work. A well-functioning labour market adjusts the demand for labour to its supply.

Full employment is an eminently feasible goal whether labour supply is growing, static or contracting. The world is not short of work to be done. The basic economic problem facing all societies is one of scarcity: there are too few resources, including labour, to meet unlimited wants. Roads need building, trees need planting, farms need developing, the sick and elderly need to be cared for, and children need to be taught.

The feasibility of full employment is apparent around the world today. A number of countries are returning to the situation of very low unemployment that characterised the 1950s and '60s. Among the OECD countries, unemployment rates in the United States, Iceland, Ireland, Luxembourg, Mexico, Netherlands, Norway and Switzerland range between 2 and 4 percent.

When unemployment prevails, what is lacking is not work but the mechanisms and incentives that connect people with jobs. The causes of modern unemployment are well understood, with labour market inflexibilities and perverse welfare incentives being the main culprits.

Labour market flexibility includes such things as labour costs, conditions of employment (including restrictions on hiring and layoffs), work practices, mobility and education and training.

Full employment is not simply about all those wanting employment having jobs. There must be strong expectations on the part of those seeking jobs to move, to retrain and, if necessary, to accept seemingly inferior jobs in the first instance. Jobs provide training (not the other way round), and entry level jobs are usually the first rung on the income ladder.

With the passing of the Employment Contracts Act in 1991, New Zealand experienced a dramatic improvement in labour market flexibility. Between 1992 and 1996 unemployment fell from 11 to 6 percent of the labour force and some 250,000 jobs were created, the fastest rate of employment growth in the OECD.

Unfortunately, Employment Court rulings undermined many of the gains, and unemployment has not fallen below 6 percent. The Employment Relations Act 2000 introduces further obstacles to job creation that will dampen employment growth. The prime minister's goal of achieving a 3 percent rate of unemployment seems unattainable with a regime that is now even more costly and cumbersome than Australia's; indeed unemployment seems likely to rise unless outward migration accelerates.

Unemployment is not simply a story about labour market flexibility; it is also a story about welfare. Benefits that are high relative to wages, high rates of benefit abatement as people move from welfare to work, and weakly applied work tests are associated with persistent unemployment.

United States experience illustrates the importance of both labour market flexibility and welfare reform. The US labour market is relatively free and un-unionised with only one in 10 private sector employees belonging to a union. The New Zealand government's aim of raising union membership to 30 percent of the workforce runs against international trends. There are no statutory rules on holidays in the United States, and surveys indicate that American workers prefer more money to more leisure. Recent US welfare reforms, including time limits on benefits, have drastically cut welfare rolls.

American firms are now desperate for workers in most skill categories. Wages of low-skilled workers have been rising faster than other wages in recent years.

A flexible labour market is particularly important for dynamic, 'new economy' industries. Federal Reserve chairman, Alan Greenspan, and other commentators have frequently pointed to the unrestrictive hiring and firing practices in the United States relative to Europe as a major explanation for its dynamism, particularly in high technology industries.

Nevertheless, changes are occurring in Europe. *The Economist* recently reported that "labour markets across Europe are becoming more flexible, almost by stealth. Governments have loosened the rules on part-time work and short-term contracts, encouraging firms to hire more workers, free of the usual job protection rules and high social security contributions that have deterred them from hiring in the past".

Meanwhile, New Zealand has been moving in the opposite direction. In order to promote job creation and 'new economy' firms we should focus on costly employment law, restrictions on dismissals, and such things as holidays and minimum wage legislation.

These factors, together with other regulations stifling businesses, tax rates and the failings of our education system are far more fundamental to the development of new industries than any number of activist industry policies. At best these merely shuffle jobs around the economy – from firms and industries that can stand on their own feet to those that are only profitable because of government assistance – and do not add to employment overall. By misallocating resources in this way, they tend to reduce economic and employment growth.

The secretary of the Australian Treasury, Ted Evans, has correctly stated that "unemployment is essentially a political choice". Unemployment only exists because governments opt for policies that benefit privileged groups such as unions but do much damage to the prospects of the least productive and most disadvantaged in the labour market.

Governments have for too long paid lip-service to unemployment. If they are serious about reducing it, they need to implement sensible employment and tax policies that encourage and reward effort while at the same time removing dependency as an option for those able to work.

SOCIAL POLICY

ARTICLE BY JAMES COX

MIDDLE CLASS WELFARE

SEPTEMBER 2001

MIDDLE CLASS WELFARE

By comparison with East Asian and most other English-speaking countries, New Zealand relies heavily on education, health and retirement incomes that are provided by the government and financed through taxation. There is less private funding of these services and incomes in New Zealand. For example, almost 80 percent of all spending on education, health and retirement incomes in New Zealand is government rather than private spending. In Australia, which has less comprehensive government provision, only two-thirds of all spending on these services and incomes is government spending.

In a book recently published by the New Zealand Business Roundtable, I argue that these differences between countries do matter. Governments must help people who would not otherwise be able to provide for themselves. But I argue that New Zealand could adopt alternative policies that involve people who can afford to do so taking greater responsibility for providing their own education, health care and retirement incomes.

New Zealand's present welfare state arrangements assume that what governments are able to provide should be sufficient for almost everyone. This assumption has become increasingly questionable as New Zealand has become more prosperous and diverse. More private funding and provision of welfare state services (such as education and health) is likely to lead to better service quality. Where services are largely provided through a government monopoly the result is only too likely to be poor service quality, rationing of services (for example, through waiting lists), lack of responsiveness to changing needs and excessive costs. There is a good deal of evidence that these are all serious problems in New Zealand today.

Much government education and health expenditure benefits better-off families. Some superannuation expenditure goes to people with substantial assets. Much superannuation expenditure benefits people who earned moderate to high incomes during their working lives. These situations result in a good deal of 'churning' of income, whereby the same family both receives substantial amounts in government benefits and pays substantial amounts in taxation.

Churning results in a welfare state that is too large. There would be no loss of fairness if both the benefits received and the taxes paid by a household were reduced by similar amounts. Moreover, a reduction in churning would permit an overall reduction in taxation. Because high taxes bias the productive decisions of taxpayers, resources are lost when a dollar of taxes is raised and then transferred back to them. This is important because New Zealand is a heavily taxed country by the standards of East Asia, the United States and Australia and a reduction in taxation would improve the prospects for economic growth.

The welfare state makes society fairer by providing income and services to people who would otherwise face hardship. However, the taxes that are used to finance the welfare state have some adverse effects on fairness. Families with children bear a particularly heavy burden because their income and expenditure needs tend to be high. High tax rates also make it harder for families to improve their circumstances by earning more. Generous benefits, excessive regulation (for example, of employment conditions) and heavy taxation all promote social exclusion by discouraging employment.

The heavy burden on families (and also on younger childless people) reflects the emphasis New Zealand's welfare state now places on providing income support and health care during retirement. Indeed it could be argued that New Zealand and some other countries are now becoming 'retirement states' rather than welfare states.

In *Middle Class Welfare*, as noted, I argue that New Zealand should adopt alternative policies based more on self-provision by better-off people. Although there are many issues that need to be considered in designing such policies, they operate successfully in overseas countries, including Australia. This does not mean that New Zealand should simply adopt any other country's policies. But it should try to learn from the experience of similar countries that have less extensive welfare states.

Middle Class Welfare does not make detailed policy recommendations. It does, however, suggest policy approaches that are worth serious consideration. For example, increased subsidies could be paid for privately provided education and health insurance, pensions for future retirees could be allowed to fall in relation to earnings, and pensions could be made payable subject to income and assets tests. These policies are a step in the right direction and may open up possibilities for future change. They are evolutionary rather than fundamental changes to New Zealand's welfare state. They would expand the range of choices available to New Zealanders.

These policies would need careful implementation. I believe, however, that the main barriers to adopting them are not technical but rather the support the welfare state receives from many people because they think it mainly redistributes income from the rich to the poor.

This is true of most spending on benefits. However, *Middle Class Welfare* shows that much spending on education, health and superannuation involves redistribution within the middle class. As this comes to be better understood, the way may be open for New Zealanders and their governments to adopt policies that will result in better services, better-directed government social assistance and lower taxes for working New Zealanders.

ARTICLE BY DAVID GREEN FOR THE
NEW ZEALAND HERALD

MEASURING POVERTY NOT A SIMPLE MATTER

AUGUST 2001

MEASURING POVERTY NOT A SIMPLE MATTER

To reach valid conclusions about poverty such as 'the poor are getting poorer' or 'there are more people below the poverty line' is no simple matter. The choice of poverty measure may well determine the result obtained.

Poverty researchers in New Zealand have generally used cash income as the measure of living standards. Occasional attempts to calculate a broader measure of material standards of living have been made.

Typically, poverty studies based on an income measure try to determine the number of people below a 'poverty line', defined as a percentage of median income. It is now widely acknowledged among recognised researchers that such measures of poverty are deficient. Any such benchmark is inevitably arbitrary. If, say, 50 percent of the median income is chosen, why not choose 40 percent or 60 percent? Moreover, such a technique almost guarantees that some proportion of the population will always be 'in poverty', regardless of increases in their overall living standards.

Martin Wolf, associate editor of the *Financial Times*, has highlighted some of the strange implications of this approach to measuring poverty. "If, for example the incomes of those with relatively low standards of living rise by a smaller proportion than the overall average, numbers in relative poverty increase. If, in contrast, the decline in incomes of those on well below average incomes is smaller than average, relative poverty declines. In the first situation poverty increases, even though everybody is better off. In the second, poverty falls, even though everybody is worse off. This seems crazy."

Annual income is also a very imperfect measure of living standards. People's income often fluctuates from year to year, and some are able to draw on savings when their income is low. Many people move from a low income decile to a higher one over time – the population 'in poverty' is not static. Cash income does not measure the value of owner-occupied housing, and some income is not reported.

For these reasons what people actually spend is a better measure of their material welfare than their income. The income measure overstates poverty. Eurostat, the European statistical agency, states that household expenditure "better reflects the availability of both declared and undeclared resources of low income groups" and is a more satisfactory indicator of 'permanent income' than income declared at some point in time.

There can be large differences in results between the income and expenditure measures of poverty. New Zealand researchers have found that only 45.6 percent of households in the lowest income decile are also in the lowest expenditure decile, and that 10 percent of households in New Zealand's bottom income decile are in the top three expenditure deciles.

Even 'expenditure' does not capture living standards fully. It leaves out goods and services in kind that are provided free to the consumer, such as health and education services. Not so long ago it was common for anti-poverty campaigners to insist on the importance of the so-called 'social wage', and trade unions made raising the social wage one of their central demands. British estimates for 1994/95 showed that low-income people received benefits in kind (mainly health and education) worth on average about NZ$12,000 per annum. Leaving out the value of these benefits ignores over 47 percent of their 'final' income. A 'consumption' measure that includes goods and services provided in kind is the most comprehensive and satisfactory measure of living standards.

No studies of poverty based on a consumption measure have been undertaken in New Zealand in recent years. The approach developed by the authors of the 1990 Planning Council report *Who Gets What? The Distribution of Income and Wealth in New Zealand* and the Department of Statistics in *The Fiscal Impact on Income Distribution 1987/88* come closest to that approach, although the allocation of some government spending and taxes to households in such studies is inevitably speculative.

Poverty is a serious social problem and poverty alleviation should be a major goal of governments – ranking above efforts to engineer any particular pattern of income distribution. Poverty alleviation is essentially dependent on policies for wealth creation and economic growth – policies of redistribution can have only limited impact, particularly in today's open international environment.

There is also a risk that a narrow focus on poverty, reflected in poverty studies based on income and even in more soundly based studies, diverts attention from the more serious underlying problem – that of welfare dependency and the incentives it creates, not least to weaken personal and family responsibility. Those who treat poverty as always and everywhere the result of sheer misfortune or a lack of cash miss important dimensions of the problem. The key issue is how society can best assist its least fortunate members without creating welfare dependency.

ARTICLE BY ROGER KERR FOR THE
NEW ZEALAND MEDICAL JOURNAL

HEALTH AND EDUCATION: GOVERNMENT FAILURE

JULY 2001

HEALTH AND EDUCATION: GOVERNMENT FAILURE

Background

There is widespread dissatisfaction with the health and tertiary education sectors in New Zealand – dissatisfaction that has persisted for the past decade despite the reforms attempted during that period. In surveys, health ranks as the number one issue that people want the government to deal with. Education features high on the list as well.

Health and tertiary education did not always stand out in this way. Fifteen years ago there was similar dissatisfaction with shoddy and over-priced goods produced by New Zealand manufacturers, the terms of access to mortgage finance, poor service by airlines, six-week waits for telephone connections, queues for taxis and much more. Most of this dissatisfaction has dissipated as choice and competition were introduced and governments pulled back from regulating and running businesses.

Some moves in the same direction were made in health and education, and even their critics acknowledge that there were important gains. Public hospitals have become more efficient and consumer-focused, universities and polytechnics have benefited from greater management autonomy, and tertiary enrolments have soared across all socio-economic groups, despite the introduction of fees. Perhaps the most dramatic gains occurred during the brief period when the accident insurance market was opened up to competition.

Moreover, in both health and education, dissatisfaction is mainly focused on areas where government involvement is pervasive. There is far less public concern with the primary health sector that is mainly private – a General Practice is typically a conventional small business – with private hospital services, and with the private education sector.

New Zealand's experience and that of other countries suggest that the reforms initiated in the 1990s were steps in the right direction. Decentralisation, moves away from political and bureaucratic control, the funder-provider split in health, competition and consumer choice saw gains for institutions, health and education professionals and patients and students alike.

The problem was not that the changes went too far but that they were too timid, piecemeal and inconsistent, and they were eroded over time rather than taken further. The government has remained heavily involved in both sectors. The decision not to allow people to opt out of state cover and use their tax dollars to buy private health insurance greatly undermined the original health reform plan. Not surprisingly, the benefits of change have been limited, the transitional costs have been high and the sectors have remained heavily politicised.

The central problem: government-dominated systems

A few years ago, the late Albert Shanker, long-time president of the American Federation of Teachers (the main US teacher union), made a startling admission. "It's time to admit", he said, "that public education operates like a planned economy, a bureaucratic system in which everybody's role is spelled out in advance and there are very few incentives for innovation and productivity. It is no surprise that our school system does not improve: it more resembles the communist economy than our own market economy".

Shanker was speaking of US schools, where the key problem is the quasi government monopoly of schooling. In more recent years, however, there has been a seemingly inexorable trend in the United States towards independent charter schools, for-profit providers and school choice through voucher-type schemes. The Bush administration seems likely to give an impetus to this movement.

By contrast with its schools system, US higher education, despite some weaknesses, is universally regarded as the best in the world. Most commentators agree that key success factors include strong competition between institutions, the large number of private universities, and the relatively high level of tuition costs met by students at many institutions, which makes them demanding consumers.

The US health system, on the other hand, has more serious weaknesses. Contrary to perceptions that they are problems of a 'market' system, most of them stem from extensive government involvement (more than 50 percent of funding comes directly or indirectly from the government) and an out-of-control tort regime. Tax incentives and other regulations distort competition, and the predominance of third-party payments for routine low cost services such as doctor visits and prescription costs means there are poor incentives to provide value for money. Nevertheless, the quality of US health care is typically high, waiting lists are seldom an issue, there are many mechanisms to cope with the needs of uninsured and low-income people (contrary to some accounts), and overt attempts to move in a more socialised direction are routinely rejected.

New Zealand's health system, apart from primary care and elective private surgery, has much more in common with the nationalised health systems of Britain and Canada. Lord Beveridge, one of the architects of Britain's National Health Service, saw it as taking Britain "halfway to Moscow". The NHS provides poor quality health care and is plagued by queues of people waiting for treatment. Canada has similar problems, despite the fact that expenditure on health has risen sharply. Some waiting lists are as long as five years.[1] By 1998, only 20 percent of Canadians considered the system needed just minor change, compared with 56 percent in 1988.[2]

It is also interesting to note that, in Europe, private insurance typically plays a much greater role than in Britain, Canada and New Zealand, and that there are many more private providers. In France, one-third of the hospitals are private, in Germany half and in the Netherlands 85 percent. Germany and Sweden have begun privatising some of their hospitals.[3]

From the consumer perspective, the problems with quasi government monopoly provision are well known. The limitations on competition and choice lead to poor quality services and high costs, as the accident compensation experience clearly demonstrated. The accident compensation (ACC) reforms resulted in significant work safety improvements in a remarkably short period of time. When services are highly subsidised or provided for 'free', there is effectively no limit on potential demand and no way of assessing priorities and value for money. Services are rationed not by

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1 James Brooke, 'Full hospitals make Canadians wait and look South', *New York Times*, 16 January 2000.

2 *NCPA Policy*, 31 January 2000, http://www.ncpa.org/ba/ba311/ba311.html.

3 Annette Tuffs, 'Germany expects more hospital privatisation', British Medical Journal, 15 April 2000. See also Heinz Redwood, *Why Ration Health Care? An international study of the United Kingdom, France, Germany and public sector health care in the USA*, CIVITAS: Institute for the Study of Civil Society, London, 2000.

willingness-to-pay judgments but by denying care, queues and other dimensions of poor quality.

Less often commented upon are the comparable frustrations of professionals in NHS-type systems. True, provider capture exists, and some succeed in 'working the system' and earning inflated incomes. But more typically such systems are characterised by the instability associated with political control and changes of government; bureaucratic red tape (for example, ACC forms); uniform and often poor rewards through public sector wage structures; and increasing difficulties in attracting and retaining staff. Health care should not be like this: it is a field that attracts many able and dedicated people who should be able to apply their skills in entrepreneurial ways and be rewarded for their performance. The provider-capture problem has been overdone: both professionals and those they serve have common interests in a better system.

Is health care really special?

Most of the mistakes made in health policy come from regarding health services as somehow special and requiring different means of provision than the vast range of other services that people use every day. The fact that food and health care are essential to life led the Soviet Union to collectivise both, with the result that food shortages became endemic and the life expectancy of Russians is still falling. The reality is that, by and large, food and health care are standard, private goods. Most people can meet routine food and health expenses out of current income or savings. Insurance can cover low probability but high-cost health contingencies for the great majority, just as people insure against the risk of damage to property and other similar events. Independent general practitioners, dentists, chemists, midwives, radiographers and, yes, hospitals can meet people's needs for health, just as farmers, restaurants and supermarkets meet their needs for food.

This does not mean there is no role for the government with respect to either food or health care. No one wants to see people deprived of adequate food or health care through lack of income, and where family and voluntary means are insufficient the government should provide support through the welfare system or direct subsidies. With both food and health care there is a case for regulation on consumer protection grounds – this includes some forms of professional regulation. With health, there are also some services that are of a public good rather than private good nature: these are things like basic medical research and public health.[4]

More detail could be added, but the essential argument is that there is no justification for the vast edifice of government regulation and control of health (and education) relative to other vital services. Most people, most of the time, are capable of making decisions in their own interests; those who are not, such as children, mentally handicapped or traumatised people and the very old have family, agents, guardians or professionals who take responsibility for them in general, not just for their health care needs. Situations that are specific to health and require specific solutions are relatively few and far between.

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4 Unlike private goods, public goods cannot be charged for directly and normally have to be financed from taxation.

Depoliticising health and education

The basic strategy needed in both health and education is a winding back of government involvement and a more direct connection between those using the services and those who pay.[5]

In a less government-dominated environment, people on middle and higher incomes would pay directly for more of their health care, with offsetting reductions in taxes. Instead of one-size-fits-all approaches there would be more scope for experimentation between fee-for-service models, integrated care, a range of insurance options, cultural forms of provision, more internet-based medicine, joint ventures with other businesses (for example, pharmacies in supermarkets), provision of services internationally and so forth. The possibilities are exciting, and there would be tangible rewards for successful entrepreneurs, as in other industries. The state could exit from many service delivery roles, perhaps through management and staff buyouts, but would maintain research, regulatory and targeted funding roles. Accident compensation would be fully privatised.

Some people may object to a smaller government role on the grounds that the poor may not have the same care as the wealthy. But as Steven Schwartz, vice-chancellor of Murdoch University in Perth, points out: "This will always be true. The important point is that the poor do not benefit when the wealthy are kept from purchasing better care. In fact, just the opposite happens. Forcing the wealthy to pay more of their own health care costs should leave more money for the poor".[6] And in a normal professional setting, how many health professionals would not supply some services free or at a highly subsidised price where the circumstances warranted?

Currently both health and tertiary education policy are moving in the opposite direction towards greater central and political control. Many members of the medical profession have never been very comfortable with such efforts by governments over the years to make them effectively state employees. Experience in New Zealand and in other countries tells us that a 'more government' model is doomed to failure and that the sectors will be subjected to yet more disruptive change in due course. The lessons from higher education in the United States and health around the world are being ignored.

Health needs are personal and highly diverse, just like people's preferences for food. Even the funder-provider split was a very inferior solution. Imagine a Food Funding Authority allocating resources for food. We should cut out the middleperson. There is no way people will get anything like the levels or types of health care services they want and are prepared to pay for through the crude mechanisms of periodic voting and political representation, as opposed to making direct buying and insurance decisions. It is a safe prediction that the sectors will remain plagued by complaints from dissatisfied consumers, low morale, political struggles, poor rewards and the loss of talented people.

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5 For a fuller account, see David Green, *From Welfare State to Civil Society*, New Zealand Business Roundtable, Wellington, 1996; and Patricia Danzon and Susan Begg, *Options for Health Care in New Zealand*, New Zealand Business Roundtable, Wellington, 1991.

6 Steven Schwartz, 'Saving Australia's Health Care System: Nostrums or Cures', *Policy*, Centre for Independent Studies, Sydney, Autumn 1999.

Moves to 'normalise' health by dismantling an NHS-style system may seem remote at this stage. So too did the moves to competition, choice and private provision in many other industries 15 years ago, and until recently the ACC scheme was a national sacred cow. Over the next 15 years the frustrations and failings of government-dominated systems in education and health, together with the costs of increasing demand for higher education and the health implications of an aging population, will force similar changes. For the sake of both those who will need these services and those engaged in providing them, it is to be hoped that changes happen sooner rather than later.

MISCELLANEOUS

YOUNG PRESIDENTS ORGANISATION

THE BUSINESS ROUNDTABLE IN 2001

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

AUCKLAND
10 OCTOBER 2001

THE BUSINESS ROUNDTABLE IN 2001

Your chairman has asked me to give you some background on the Business Roundtable, describe how we function, outline issues and research projects on our agenda, and discuss the results and influence we are achieving.

He has also invited me to offer some views on whether New Zealand has a first world or a third world future, whether businesses and business people like yourselves should stay or leave, whether New Zealanders really want economic success, and how business people can help bring about change. Those are thought-provoking questions.

Let me start with a quick sketch of the organisation. The New Zealand Business Roundtable (NZBR) comprises primarily chief executives of major New Zealand businesses. The United States Business Roundtable and the Business Council of Australia are similar organisations of chief executive officers (CEOs) with around 200 and 90 members respectively. You need an organisation constituted to meet the needs of busy people running large firms if you want them to take an interest in national affairs.

Currently we have some 50 ordinary members and half-a-dozen associate members – prominent business people who are not chief executives. That is about the optimum to keep our size manageable. Membership is by invitation but we welcome the involvement of business leaders who share our aims. There is a regular turnover due mainly to retirements, transfers or company re-organisations. This year 15 new members have joined. Murray Horn, managing director of the ANZ Banking Group, is currently our acting chairman.

Our aim, as set out in our statement of purpose, is unchanged since the organisation's formal establishment in 1986. It is to contribute to the overall development of New Zealand and promote the interests of all New Zealanders concerned with achieving a more prosperous economy and fairer society. Societies that are prosperous can also afford a safer, cleaner environment and better look after older people and the needy. We believe these objectives are best achieved by policies for open competitive markets, excellence in the provision of core public services, modest taxes and moderate regulations.

We do not seek to advance the interests of business at the expense of the interests of workers, consumers or any other group. We emphatically oppose policies designed to protect any existing firm or industry from competition. Protection from competition hurts consumers and holds back innovation. Competition and free markets redistribute wealth and resources from vested interests to ordinary people. We have often advocated policies that are not in the immediate interests of any particular member or group of members but which, we believe, serve the common interest. Nor are we against not-for-profit organisations – we are one ourselves.

I think most members join the NZBR because, as individuals, they want to help promote a better New Zealand. There is also the consideration – an element of self-interest if you like, and a justification for paying the bills – that businesses at large will only do well in a healthy, growing economy.

I run a small office in Wellington with one research assistant and two administrative staff. Most of our resources go on research, usually undertaken by New Zealand or overseas academics or other experts, and on communications, which includes bringing overseas speakers to New Zealand. In a sense we combine the features of a think tank and a business organisation.

Our prime focus is on the overall direction of economic and social policy and on issues that have a major influence on the country's well-being. Thus, one of our reports this year brought out the contrasts between New Zealand's policy record over the past decade and the directions in which more successful countries have been moving.

This year we have also published studies, some of them book-length, on public sector management, corporate social responsibility, the idea of a currency union, poverty and benefit dependency, the impact of high government spending and taxation on economic performance, and middle class welfare – government provision of services to people who are comfortably off. The next publications will be on options for constraining government regulation and the risks of a Tasmanian future for New Zealand. In the pipeline are major books on education and the family, the latter as part of our interest in welfare.

This year we have also made substantial submissions in response to the Budget Policy Statement, the superannuation fund proposal, the government's tax review, the discussion paper on the Privy Council issue, the review of the 1981 Public Works Act and the dairy industry legislation. We network closely with other business organisations, and through our involvement with the Local Government Forum, the Resource Management Business Forum and the Education Forum we have made submissions on local government, resource management and education issues. All of this material is in the public domain and on our website, www.nzbr.org.nz.

How much influence does our work have? At times we have been pleased that changes we have advocated have happened, and at other times we have been disappointed that what we regard as good arguments have gone unheeded. But there have been many other players besides ourselves in all these debates and it is impossible to know how much our involvement mattered. We aim to undertake quality research and influence thinking on the basis of sound arguments, not to exercise lobbying 'clout'. If the reasoning is sound, we hope it will be listened to; if not, it deserves to be ignored. Sooner or later good ideas tend to drive out bad. Decisions are ultimately the outcomes of the democratic process, which is as it should be.

Some people say that we had a lot of influence during the country's two waves of economic reform but less in recent years. To the extent that our influence made a difference and that moves we have advocated such as deregulation, privatisation and lower taxation have stalled or been reversed, that observation is obviously true. That is a problem for us. But it is even more a problem for the country if these, and other developments that are happening worldwide, have merit and are not happening here.

Media and other commentators often talk about who has the 'ear' of the government – who's in and who's out in Wellington. We have never wanted to be an old-style lobbying organisation, seeking influence or doing deals behind closed doors. We have always sought to have good relations and open dialogue with governments and opposition parties in a non-partisan way. We had Michael Cullen to our last meeting and Jim Sutton earlier in the year; Bill English will be joining us in November. We have innumerable contacts with select committees, official inquiries and government agencies. We have never felt that we have not been listened to, even though there have been plenty of occasions when our views have not been accepted.

A key point to make here is that policy debates are about much more than the views of a government at a particular point in time. Governments change, as do the policies of individual political parties. Ultimately what drives policies are general community views and attitudes – the democratic process reflects them. Much of our effort is directed at public understanding, including working with the media which have an important role in informing and educating the public.

A good illustration of this point is the removal of the dairy industry's single desk monopoly just this month. We argued for more than 10 years that the industry should be deregulated to improve its contribution to the economy. For most of that time there was hostile resistance by the industry and no support from incumbent governments. Gradually opinion changed to the point that the industry itself started making our arguments to politicians. Similarly, it will be interesting to observe the political reactions to the government's tax review. Its thinking is very much in line with our view that New Zealand needs to stand out from other countries with a lower, flatter tax scale. There is now a broad constituency for moves in this direction among business organisations and tax professionals. At present the government is not well disposed to such moves. Over time, political parties will be forced to confront the weight of these arguments.

It goes without saying that challenging sacred cows like producer boards or union privileges and arguing for change is seldom a popular role. It has involved plenty of flak and negative perceptions, and a good deal of playing the man rather than the ball. The more an organisation is thought to be influential the more it is likely to be a target of people whose vested interests or views are threatened.

Criticism goes with the territory on any new issue. Initiatives we supported such as GST, the Reserve Bank of New Zealand Act 1989 and freeing up shop trading hours were highly controversial at the time. We made ourselves unpopular with the National Party by criticising their opposition to GST. As I recall, we were joined only by Federated Farmers among business organisations in supporting the Reserve Bank of New Zealand Act 1989. Shop workers protested at our office over trading hours. Today few would wish to turn the clock back on these changes.

Negative perceptions seem to have faded somewhat: a poll last year found 36 percent of people saying they viewed the NZBR favourably and 48 percent said they thought we did a good job – much the same ratings as the former Employers Federation and the Council of Trade Unions and well above ratings in earlier years. Part of what we struggle with are the more general anti-business and anti-market attitudes in New Zealand that hold the country back. It would also be easy to be more popular by keeping our head down and going along with the status quo – many in business do just that. But that is hardly consistent with our aim of wanting to see New Zealand do better.

We remain ambitious for New Zealand. No one in business has an interest in talking the economy down but equally no one should pretend that things are satisfactory when they are not. Deep down I think most political parties and most of the public know that the country's economic changes were necessary and beneficial. But the main ones are almost 10 years in the past; New Zealand has stood still or gone backwards while other countries have moved on, and the current outlook is no better than mediocre. Ten years ago New Zealand was ahead of Australia in a number of policy areas; today I would gladly swap Australia's overall policy package for ours.

There is no reason why New Zealand could not climb back up the international income rankings. The country does not lack resources, including business skills. Most businesses meet the capital market test of covering their cost of capital. There have been a handful of egregious failures but, despite their size, they do not account for the country's problems in generating wealth. Essentially, what matters for modern economic growth is superior policies and institutions – like political arrangements and sound laws. Tasmania is a warning of what happens to a country that lacks advantages of size and location and persists in shooting itself in the foot.

Do New Zealanders really want to do better? Some are content with mediocrity: Jim Bolger used to say we were "too ambitious". However, I think most want to get ahead. A recent report of the New Zealand Study of Values found that relative to citizens of comparable countries, New Zealanders were keener on economic growth, more interested in money, and less well disposed to Green ideologies. Trade unions have not stopped making wage claims. The worry, however, is that more of those who want to get ahead will take the opportunities to do so that abound around the world today.

How should talented and ambitious business people, who are also dedicated New Zealanders but frustrated by a mediocre environment, size up their options? Some may have little choice. Their firms may reach the limits of the New Zealand market and have to move offshore if they want to grow. The problem is not that this happens but that it sometimes happens for the wrong reasons. Those managing public companies are duty bound in the interests of their shareholders to seek opportunities in bigger and faster-growing markets if the domestic environment is poor. Flight is also, in many ways, the easier option: it involves less hassle, often less tax, and escape from a culture that does not look very favourably on business success. Committed New Zealanders can still contribute to the common cause from abroad.

The alternative is to stay and fight for a better future for the country from a home base. I have great respect for leading New Zealand business people who have stood up for economic changes, sometimes to the short-term cost of their own businesses. I have less respect for prominent business people who have benefited enormously from things like the removal of import licensing and tariffs, better employment law and deregulated domestic markets, but have stood aside from the fray in the interests of popularity and taken a free ride on the efforts of others. Nor is it enough to talk endlessly about the need for national leadership, adding value, changes of attitude and other business-speak banalities. It is necessary to engage in the difficult policy debates on issues such as tax, education and welfare that Don Brash was raising at the Knowledge Wave conference. The only way I know of winning such arguments is by arguing.

Time is now not on New Zealand's side. We have squandered nearly a decade of opportunities to build on the earlier gains. The short-term economic outlook may take a turn for the worse. No economic commentators see New Zealand being more than a 2–3 percent growth economy in the medium term. This is a recipe for ongoing decline.

It is a year since the government responded to criticism that it was anti-business and sought a positive dialogue with the business sector. That change was welcome and the business community has worked to engage constructively on policy issues. As yet, however, little of substance has emerged. Initiatives in areas from employment law to environmental regulation to local government are being mooted that would depress growth prospects further. Business organisations are now looking for serious responses to their concerns. A recent survey in the *National Business Review* reported that 77 percent of chief executives believed the government does not have the policies to lead New Zealand to economic prosperity. We need more voices in business, politics and the media urging changes that would get the country back on to a better path.

I do not have a crystal ball that answers your president's question: "Should we emigrate now, while we are still young enough, to countries that will provide better opportunities for ourselves and our families, or stay in New Zealand and risk becoming part of the third world?". What I do know is that the collective choices we make will determine whether New Zealand stays part of the first world. As the late Mancur Olson, one of the world's leading writers on the rise and decline of nations, has put it: "Those countries with the best policies and institutions achieve most of their potential, while other countries achieve only a tiny fraction of their potential income". Olson went on to say that:

> … the large differences in per capita income across countries cannot be explained by differences in access to the world's stock of productive knowledge or to its capital markets, by differences in the ratio of population to land or natural resources, or by differences in the quality of marketable human capital or personal culture … The only remaining plausible explanation is that the great differences in the wealth of nations are mainly due to differences in the quality of their institutions and economic policies.

In other words, the choice between a first world and a third world future for New Zealand has little to do with our natural endowments or with the rest of the world. Decisions about the quality of our institutions and policies rest squarely in the hands of New Zealanders and their governments.

ARTICLE BY DAVID HENDERSON FOR
THE INDEPENDENT

WHAT'S WRONG WITH CORPORATE SOCIAL RESPONSIBILITY?

JUNE 2001

WHAT'S WRONG WITH 'CORPORATE SOCIAL RESPONSIBILITY'

Issues concerning the social responsibilities of private businesses have been the subject of debate and dispute for decades if not centuries. But in recent years a new way of thinking on the subject has arisen and taken hold. Both in the business world and outside it, there is wide and growing support for today's conception of Corporate Social Responsibility (CSR).

New vistas

According to CSR, the combination of changed economic conditions and pressures from public opinion now requires businesses to take on a new role, a new mission. They should play a leading part in reshaping the world, and embrace the notion of 'corporate citizenship'. They should run their affairs, in close conjunction with an array of different 'stakeholders', so as to pursue the goal of 'sustainable development'. Sustainable development is said to have three dimensions – 'economic', 'environmental' and 'social'. Hence companies should set objectives, measure their performance, and have that performance independently audited, in relation to all three. They should aim to meet the 'triple bottom line', rather than focusing narrowly on profitability and shareholder value.

Only by acting in this way (so the argument goes) can businesses respond to 'society's expectations'. In this lies the key to long-run commercial success for individual firms, since profits depend on reputation, which in turn depends increasingly on being seen to act in a socially responsible way. Thus, taking the path of CSR will in fact be good for enterprise profitability. Further, its adoption by businesses generally is necessary to ensure continuing public support for the private enterprise system as a whole. Capitalism has to be given 'a human face'.

Corporate Social Responsibility has caught on. It has been endorsed by a substantial and growing number of businesses, especially among the large multinational enterprises (MNEs) that are especially vulnerable to attacks, and by academics and commentators in and around the business world. It is favoured, and often demanded, by so-called 'public interest' non-governmental organisations (NGOs), many of which are among the strongest critics of business in general and MNEs in particular. It is insisted on by investment institutions that stand for 'socially responsible investment'. It is advocated by a growing army of advisers and consultants, who stand ready to assist firms in defining their new goals and auditing their performance. Last, but far from least, many governments are attracted by the general notion. On the other side, CSR has few opponents or serious critics. There is a broad consensus in its favour.

I believe that this consensus view is misguided. The doctrine of CSR rests on a false view of reality, and putting it into effect will have damaging consequences for people in general even if some businesses gain.

False picture

The picture of the world that CSR presents is at fault in several respects. For one thing, neither sustainable development nor the means to achieving it are either well defined or universally agreed. It is not the case, as the supporters of CSR typically assume, that in these issues of policy there are well-specified problems with known 'solutions'. The present notion of sustainable development forms a poor basis for redefining the scope and purpose of modern business.

The notion of 'society's expectations' is likewise open to question. Many supporters of CSR simply assume that these expectations are represented by what the critics of business among the NGOs are saying. But it is doubtful whether what most people now expect of businesses is that they should work with 'stakeholders' in pursuit of sustainable development and the 'triple bottom line', even though this could well result in higher costs and prices for the products and services in question.

Often, though not always, CSR advocates, both in the business world and outside, are adherents of what I call g*lobal salvationism*. This goes with acceptance of alarmist views on the state of the environment and the damage done to it by business-related activities, a belief that fateful choices now have to be made on behalf of humanity and the planet, and a distorted view of globalisation and its effects.

Contrary to the salvationists, it is not the case that globalisation has brought with it 'social exclusion', nor has it 'marginalised' poor countries. Again, it has not brought disproportionate benefits to MNEs in particular, nor has it increased their power to influence events while reducing that of governments. To the contrary: governments retain their capacity to act, while privatisation, deregulation and the freeing of cross-border trade and capital flows have *reduced* the economic power of businesses by making markets more open and competitive. The idea that businesses now have to take on new and wider social responsibilities, because they have become more powerful while governments have become weaker, has no basis.

But the trouble with CSR is not just that is rests on dubious or false assumptions. Carrying it into effect is liable to do positive harm.

Reducing welfare

Within businesses, the adoption of CSR carries with it a high probability of cost increases and impaired performance. Managers have to take account of a wider range of goals and concerns, and to involve themselves in new and time-consuming processes of consultation with outside stakeholders. New systems of accounting, monitoring and auditing are called for. On top of all this, the adoption of more exacting self-chosen environmental and 'social' standards is liable to add to costs, all the more so if firms demand observance of these same standards by their partners, suppliers and contractors.

Contrary to what is often assumed by supporters of CSR, it is not the case that progress necessarily results from the adoption of 'higher' norms and standards. There are many instances where insistence on these has brought higher costs for small or dubious benefits. There is an obvious risk that, in the name of CSR and in response to 'society's expectations', firms will find themselves going down that path. This would make everyone worse off.

In so far as 'socially responsible' businesses find that their new role is bringing with it higher costs and lower profits, they have a strong interest in having their unregenerate rivals compelled to follow suit, whether through public pressure or government regulation. The effect of such enforced uniformity is to limit competition and hence to worsen the performance of the economy as a whole. The system effects of CSR, as well as the enterprise effects, will tend to make people in general poorer.

The greatest potential for harm of this kind arises from attempts, whether by governments or by businesses in the name of CSR and 'global corporate citizenship', to impose worldwide norms and standards. Since circumstances differ widely across countries, such regulatory actions would restrict the scope for mutually beneficial trade and investment flows. In particular, they would hold back the development of poor countries by suppressing employment opportunities within them.

Prominent businesses that have adopted CSR have lent their support to dubious corporatist notions of 'global governance', in which business joins hand with governments, international agencies and leading NGOs to raise standards across the world. Besides carrying with it the danger of over-regulating the world economy, this confers on organisations that are not politically accountable powers and responsibilities that do not rightly belong to them.

Corporate irresponsibility

In embracing CSR, many corporations and business organisations have failed to contest, or have even endorsed, the arguments and demands of anti-business activist groups. They have treated these arguments and demands as reflecting the views of 'society'. They have failed to make an effective case for the market economy. Many of their public statements show little regard for easily accessible facts, arguments and ideas. With few exceptions, the contribution of the business world to public debate on these broad issues of public policy has been, and continues to be, inadequate or worse. It is high time for leading corporations to consider how they could improve this state of affairs.

Striking a balance

None of this is to say that the problems confronting businesses today are straightforward and easily manageable. Now as always, companies have moral as well as legal obligations. Now, more than ever, companies are under pressure. They have to show that they treat people in ways that are fair and humane, that their activities are not giving rise to damaging external effects, and that, where current environmental and social concerns appear to them well founded, they are ready to contribute, in ways that are consistent with their primary purpose and obligations as commercial entities, to common efforts to deal with these.

All the same, it is quite wrong to think that profit-making is something largely separate from the contribution that business makes to the general welfare. In a competitive market economy, firms make profits, and can only make profits, by providing products that people wish to buy of their own free choice, and by being enterprising and innovative in doing so. The best way to ensure a positive role for business is to extend the scope and improve the functioning of markets.

The advocates of CSR want to remake capitalism anew. They show little awareness that the case for private business depends on its links with competition and economic freedom. Instead, they see defence of the market economy in terms of making businesses more popular and respected, through meeting 'society's expectations' that they identify with current radical programmes for change.

Like sustainable development, corporate social responsibility is an appealing notion. But the current widely held doctrine of CSR is deeply flawed. It rests on a mistaken view of issues and events, and its general adoption by businesses would reduce welfare and undermine the market economy.

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON APPEALS TO THE PRIVY COUNCIL

APRIL 2001

SUBMISSION ON APPEALS TO THE PRIVY COUNCIL

1 Introduction

1.1 This submission is made by the New Zealand Business Roundtable (NZBR), 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.

1.2 The submission responds to the discussion document *Reshaping New Zealand's Appeal Structure* (December 2000), referred to below as 'the discussion document'. The document appears to take it as a forgone conclusion that appeals to the Privy Council will be abolished and implies that discussion is only required as to the new appeals system. For this reason, many businesses and business organisations have not troubled to respond to the discussion document. However, the NZBR considers the fundamental issues relating to any move to abolish appeals need to be addressed.

1.3 Major commercial enterprises constitute the most significant group of users of the Privy Council's services as the final appellate court for New Zealand. This submission is made from the standpoint of the commercial community. It is notable that of the nine cases decided by the Privy Council and reported in the [2000] *New Zealand Law Reports* (that is, all substantive judgments of the Privy Council during the relevant period), six involved commercial enterprises (three being government-owned), one of the remaining three cases involved the right to earn a living, and major commercial interests were at stake in another. Contrary to claims that cases are increasingly being sent back to New Zealand, only one of these cases (not a commercial case) was remitted. There does not appear to be any fall-off in recourse to the Privy Council. By the end of April 2001, five further judgments had already been given and other cases were outstanding. These continue the dominant pattern of appeals being commercial and private law matters, as shown in the Annex.

1.4 The conclusion of this submission is that, from a practical point of view, there are currently benefits from retaining appeals to the Privy Council. Other issues to do with the functioning of the courts and the appeal system should be addressed before this step is considered. The arguments for abolishing appeals appear to be promoted primarily by people and organisations that are unlikely to be involved in major litigation and appear to reflect concerns other than those felt by actual litigants.

2 Alternatives proposed in the discussion document

2.1 The NZBR believes any jurisdiction needs a final court of appeal that has the time to give careful consideration to a small number of cases of general public importance. This dictates the structure of the appeal system, since if the judges of that court are also judges of a busy appeal court that hears a large number of appeals from trials, that object is largely defeated. It follows that there must be a second appeal, and any court structure involving only one appeal – Option One in the discussion document – is not supported.

2.2 The other two options canvassed in the paper are essentially the same. The only difference between the proposed appeal tier of the High Court and a divisional court of the Court of Appeal is the presence of one Court of Appeal judge on the latter. Both these proposals essentially reflect the Court of Appeal's current practice of hearing a large number of cases before divisional courts composed of one Court of Appeal judge and two High Court judges. Experience with the divisional court system has not been uniformly happy. In both the criminal and commercial areas, cases have been mishandled by divisional courts and major confusion has resulted. *Carter Holt Harvey v McKernan* [1998] 3 NZLR 403 was particularly embarrassing and, but for a procedural stratagem, would have resulted in the inadequacies of a divisional court being exposed in the Privy Council. *R v Sew Hoy* provides an example of the divisional court system preventing the court from clearing up confusion on an important matter, as to have done so would have involved overruling the decision of a 'proper' bench of the Court of Appeal. A litigant who appeals to the Court of Appeal expects to have the case dealt with by a court of three appeal judges. The divisional court system is not a good precedent for a first stage appeal and the current system of five-judge benches and divisional courts gives the worst of both worlds, wasting resources on some cases and providing inadequate service for others.

2.3 All three options assume that our Court of Appeal, constituted as at present, is suitable as a court of final appeal. Much of the debate has been conducted on the basis that it is now ready to assume this role. The NZBR does not wish to get into a debate about the quality of our current judges.[1] It seems inappropriate, however, to compare our Court of Appeal with the Privy Council which is the Judicial Committee of the House of Lords. The proper comparison for our Court of Appeal is with the English Court of Appeal. There is no reason to suppose that our Court of Appeal is of any lower quality than the English counterpart, even though New Zealand has proportionately more Court of Appeal judges than England and Wales. But nor is there any reason to suppose that it is markedly superior to the English equivalent and capable of replacing the highest level of appeal.

2.4 Two further options have been canvassed and warrant comment in case they are given serious consideration. These are:

- that there should be a single point of entry into the court system, with all cases starting in the District Court and with appeals to the High Court and thence to the Court of Appeal; and
- that a court of final appeal should include distinguished jurists from overseas.

2.5 The NZBR agrees with the discussion document that there should not be a single point of entry into the court system for commercial cases at District Court level. It is clear that few District Court judges are as experienced in commercial

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1 In a recent paper, James Farmer QC has written:

> I would suggest it is naïve to expect that a small country like New Zealand can *consistently* match the quality of Judges at the highest level in the United Kingdom, given the much greater size of the English bar from which Judges are drawn.

Farmer also makes the point that it cannot be assumed that the standard of the local judiciary will always match what it has been in the past given changing career patterns and opportunities.

James Farmer, 'The Judicial Process in New Zealand', Legal Research Education Foundation seminar, Auckland, 2 March 2001.

matters as High Court judges are, and many have no real commercial litigation experience at all. Indeed they are not expected to be experienced in dealing with commercial cases. Nor do District Court judges acquire, while sitting in that capacity, much experience that would equip them to deal with major commercial litigation. It seems unreasonable to expect the same judges to be able to deal both with a large number of summary criminal matters on the one hand and with indictable criminal cases and significant commercial cases. Nor does it seem a sensible use of resources. If a 'single point of entry' were to be adopted, therefore, it is likely that by some device – such as warrants to hear civil cases – two separate groups of judges would in fact be created, in which case the pretence that all cases were being heard by the same court might as well be abandoned.

2.6 The NZBR would not oppose in principle the proposal that there should be a court of final appeal that included distinguished jurists from overseas. But there is a flavour of 'window dressing' in the proposal. One overseas judge – or even two – involved on an occasional basis will not produce the unarguable independence that the Privy Council has from the conventional wisdom and perhaps prejudices of a New Zealand legal 'establishment'. Nor is it clear that the practicalities have been worked through. No research appears to have been conducted into whether senior judges from target countries like Britain, Canada and Australia would be willing to take part or would be made available by their governments, and on what terms. Any requirement for full cost recovery would almost certainly be prohibitively expensive. Generally the use of retired judges would not be desirable. The practical problems involved in operating a final court of appeal on this basis have not been examined, but seem formidable at first glance. It seems likely that the cost to the New Zealand taxpayer would be much higher than the present arrangements and the resulting court of lower quality than the Privy Council. It is also not clear that even with, say, a doubling in final appeals there would be sufficient work to employ fully two or three New Zealand judges. If, on the other hand, the same judges were also rostered to deal with routine appeals in the Court of Appeal, the point of having a court of final appeal is largely defeated.

2.7 The desirable shape of the appeal system is therefore much as at present, namely two tiers of entry with major commercial cases going straight to the High Court, and two levels of appeal culminating in appeal to a court of final appeal that has time to devote serious consideration to a few cases of general public importance. Since no proposal has been made that would obviously be superior to the Privy Council in quality or efficiency, the question has to be asked whether there is any compelling reason to sever appeals to the Privy Council.

3 Arguments for abolishing appeals to Privy Council

3.1 Arguments used to justify severing appeals to the Privy Council need to be scrutinised to see whether they carry any real weight, or whether they raise issues that can be dealt with in other ways.

3.2 The first of these is 'sovereignty'. Maintaining appeals to the Privy Council is an exercise of sovereignty and may be all the more independent-minded for the fact that it arguably goes against a trend. In *Tangiora v Wellington District Legal*

Services Committee [2000] 1 NZLR 17, at p 20, the Privy Council took the trouble to point out:

> The Judicial Committee was created by an Act of the Imperial Parliament in 1833 … The 1833 Act … remains part of the statute law of New Zealand today by virtue of the Imperial Laws Application Act 1988 of New Zealand.

In other words, appeal to the Privy Council occurs by permission of the New Zealand parliament.

3.3 The national sovereignty argument is unconvincing for two further reasons:

- the United Kingdom has now subjected itself to being bound in international law by the decisions of the European Court of Human Rights (ECHR) and has allowed its domestic law to be bound by decisions of the European Court of Justice (ECJ). These constitute far greater derogations of sovereignty than use of the Privy Council. The Privy Council is bound to apply New Zealand statute whereas the ECHR can require that the United Kingdom repeal or amend statutes and the ECJ can simply declare them ineffective; and
- New Zealand has allowed an individual right of complaint to a number of bodies such as the Human Rights Committee and committees set up under subsequent conventions. Again, these conventions are a more far-reaching derogation of sovereignty as United Nations committees can comment on New Zealand statutes and government policies and recommend changes.

3.4 The second argument is that the Privy Council is ineffective as a court of final appeal as it only hears 10 or so cases a year. This argument assumes that the law is in constant need of explanation and guidance. This should not be so, particularly in the commercial arena. To the extent that it is, it indicates a deficiency in legislation rather than in the court system. It should also not be forgotten that New Zealand benefits from numerous decisions of the Privy Council from other jurisdictions in common law matters, and of the High Court of Australia in appropriate areas such as company law. New Zealand cases in the Privy Council have also made a contribution to the development of the common law in important ways for example, *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 3 NZLR 7.

3.5 A related matter is the question of cost. At first blush it appears that an appeal to the Privy Council would be expensive for the parties. The evidence is not clear-cut, however. Numerous parties involved in litigation have advised the NZBR that their appeals to the Privy Council were no more than might be expected for a further appeal (for example, $150,000 on top of a bill that had already reached $650,000 in the High Court and Court of Appeal), or even that their costs in the Privy Council were lower than in the Court of Appeal. With the exception of the costs of Privy Council Agents in London, there seems little reason to suppose that costs would be much lower in appealing to a local court of final appeal. The figures given in the discussion document for the relative costs to Crown Law of appeals to the Court of Appeal and the Privy Council seem so out of kilter with private sector experience that it would be interesting to expose them to independent scrutiny.

3.6 A further argument is that large numbers of jurisdictions have severed appeals and New Zealand is now left with a collection of tiny Crown Colonies and a few very small independent states. In fact, appeals have been severed by two main groups of countries. On the one hand are Canada and Australia, both of which have populations and legal professions many times the size of our own. On the other hand are a large number of African and Asian states that have a poor reputation, to put it mildly, for maintaining the rule of law and protecting minority rights. The most recent jurisdiction to go was, of course, Hong Kong and it seems extraordinary that the government should use an example where the decision was taken clearly contrary to the wishes of the bulk of its population. Other countries including Trinidad and Tobago, which is a republic, have maintained appeals. Furthermore, several of those jurisdictions, including, for example, the British Virgin Islands, the Cayman Islands and the Turcs and Caicos Islands, being tax havens, generate major commercial litigation and appeal commercially significant cases to the Privy Council. The Privy Council has, in the last six months, decided cases from the British Virgin Islands and the Cayman Islands that raise fundamental legal questions that will impact on New Zealand law.

3.7 What may, in reality, be the core argument appeals to judicial understanding of local 'social thinking', a somewhat ill-defined concept. This is an argument for local autonomy based on the proposition that there are particular conditions in New Zealand that dictate that the law develop in a unique way. But New Zealand commercial law is not different from that of other jurisdictions in any relevant sense. Indeed, the last few decades have been characterised by efforts to harmonise commercial law through adopting models from other countries and adopting harmonising conventions. It appears contradictory on the one hand to harmonise legislation and on the other to claim that New Zealand courts should follow a distinctive path in interpreting it. Furthermore, and particularly in a small country, detachment and objectivity can be valuable in upholding the rule of law and ensuring that local conditions and local knowledge do not distort principle and justice.

3.8 A related argument concerns the ability of the New Zealand courts to shape and direct the development of the law. The reasons why the abolition of appeals to London is opposed by many in the business community were neatly encapsulated in the commentary by Andrew Beck in the March 2001 issue of the *New Zealand Law Journal*. Writing in favour of severing appeals, Mr Beck noted that:

> … because the Court of Appeal has not been the final body responsible for the determination of all New Zealand's law, it has not had a free hand … this has made it quite impossible for the Court to pursue a uniform policy.

Mr Beck added:

> When it comes to substantive hearings, the Court would be able to play the true role of a final decision maker. With no one looking over its shoulder it would be able to pronounce with confidence on the law as it ought to be …

What is proposed here (by an expert in civil procedure) is a major change in the role of the Court of Appeal. A court is supposed to decide cases without favour, on the basis of principle and precedent and the argument presented by the parties. For courts to discuss policies to be adopted in relation to particular matters in advance would amount to a major failure of natural justice, as would the court seeking information that might affect its decisions in the absence of a party or its counsel.

3.9 Essentially, what is proposed is that the court of final appeal should become a policy-oriented body supplanting the proper role of the legislature. Although this argument is not explicit in the discussion document, it is clear that it is a widespread expectation both among supporters and opponents of abolition of appeals to London. Furthermore, once there are no appeals beyond the Court of Appeal, and if that court habitually sits as a single bench including all or nearly all the judges in one sitting, there will be no restraint to prevent the court from behaving in this way. The temptation to do so will present itself and the court has already shown that it can succumb to such temptation. Thus, it seems that for some proponents of abolition the central objective is to promote a radical change in the role of the courts.

3.10 In order to see how the Court of Appeal would be likely to conduct itself once liberated from supervision by the Privy Council, one can look at areas of law where there is already no appeal or where appeal can only be mounted with difficulty. In *Brighouse v Bilderbeck* [1995] 1 NZLR 158, a controversially constituted Court of Appeal wrote new law in the area of redundancy compensation, and the members of the majority admitted that they were writing new law. Since the case concerned an appeal from the Employment Court there was no appeal to the Privy Council. Had such an appeal existed, it seems doubtful that the Court of Appeal would have made this decision. This case was effectively reversed by the current Court of Appeal in *Aoraki Corp v McGavin* [1998] 3 NZLR 276. For the business community major changes of direction by the court depending upon who is on the bench are costly, disruptive and unacceptable.

3.11 Likewise, in *Z v Z* [1997] 2 NZLR 258, dealing with an interlocutory issue that had arisen in a case before the High Court, the current Court of Appeal engaged in extraordinary procedures to enable it to decide issues the parties did not want argued but which the court wished to rule upon. The court then refused leave to appeal to the Privy Council, which it had the power to do because the matter was an interlocutory decision and not a final determination. This challenged the parties to mount an application for special leave to appeal on an interlocutory issue in a proceeding that still had not come to a substantive hearing in the High Court. The Court of Appeal appears to have banked on the parties not only not applying for special leave to appeal but also on them settling the case so that no substantive appeal occurred. That is what eventually happened.

3.12 These cases demonstrate that the central issue is not the quality of the judges but whether they apply the law without fear or favour, and only on the basis of the arguments of parties. Experience has shown that in high profile cases in a small country judges cannot always be relied on to uphold the rule of law, as opposed to being swayed by politically correct or even majority opinion. The value of the Privy Council has most recently been illustrated in two successful appeals in which our Chief Justice sat with the four Law Lords. In *Valentines Properties Ltd v Huntco Corporation Ltd*, a commercially realistic contractual interpretation was provided (reversing both the High Court and Court of Appeal). In *Harley v McDonald* an unfair imposition of costs on a barrister who had evidently irritated the High Court judge was set aside, again reversing the High Court and the Court of Appeal.

3.13 In short, the degree of influence that the Privy Council has had on the New Zealand legal system goes far beyond the number of cases it has heard from New Zealand. The mere existence of appeals to the Privy Council has an impact on the conduct of our courts. We believe that none of the reasons advanced for severing appeals carries weight with most of the parties who actually litigate in the Privy Council, and some of the arguments for severing appeals are considered alarming by large sections of the business community.

4 Consequences for business of severing appeals to the Privy Council

4.1 It is clear that there is a considerable element of sovereign risk in commercial dealings with entities in New Zealand. Its governments in the last 15 years have been prone to make rapid changes in policy, and to fail to address outstanding problems. One of the advantages of dealing with New Zealand is that it has, for its size, a relatively competent, reliable judiciary with a high level of integrity at the personal level. However, there are some key issues involving overseas business relations that are of concern.

4.2 The first of these is professional indemnity insurance. All professional indemnity insurance is laid off offshore, which means that premium rates are vulnerable to perceptions of risk in New Zealand. The courts in many jurisdictions have had an erratic record on professional liability, but the enthusiasm for finding insured professionals liable for a range of new losses has been dampened recently in overseas courts. New Zealand courts, deservedly or undeservedly, have a reputation for looking for deep pockets to compensate those who have suffered losses (*Hamlin v Invercargill City Council* comes into this category of case). If this perception is held by overseas reinsurers then professional indemnity insurance premium rates are bound to rise if appeals to the Privy Council are severed.

4.3 Similar issues arise with choice of law clauses. Anecdotal evidence suggests that the ability to take disputes as far as the Privy Council is an important factor, if not the most important factor, in obtaining consent to a New Zealand choice of law clause in overseas transactions. Many foreign business people do not have the time or inclination to make detailed enquiry about the New Zealand legal system. If an international benchmark in the form of appeals to London is removed, they may well refuse to deal with the New Zealand legal system at all. The loss of New Zealand choice of law clauses in international contracts will mean greater uncertainty and cost for New Zealand businesses and a loss of business to the New Zealand legal profession.

4.4 Two other matters in the discussion document raise concerns. One is the implication that the business community can always resort to arbitration, and so the quality and reliability of the court system on this presumption may matter less. Apart from the fact that this is an odd justification for the government to be offering, there are disadvantages to arbitration. Being confidential, it does not generate any public good in the form of refinement of the rules. A system depending entirely on arbitration would therefore be a highly uncertain system in which almost every dispute would have to go to arbitration instead of being settled on legal advice based on precedent. It is not therefore a substitute for a properly functioning court system.

4.5 The other matter is the statement that Maori concerns might be assuaged by consultation on judicial appointments. There seems no reason why consultation should be limited to matters Maori. It is already a concern that ministers responsible for portfolios such as Maori affairs and women's affairs and not representatives of the business community are consulted on judicial appointments. The ministries involved have a reputation for being anti-business and for having little understanding of the dynamic effects of their ideas. At the same time there are justified concerns that consultation could result in politicisation of judicial appointments.

4.6 In summary, the Privy Council has served New Zealand well. It significantly enhances the respectability of the judicial system of New Zealand, as a small remote country, in the eyes of the international commercial community. Because appointments to the Privy Council are not controlled by the New Zealand government, it reinforces the separation of powers between the judiciary and the other branches of government. The NZBR believes that a heavy onus is on those who propose abolition of appeals to the Privy Council to identify the gains that would justify discarding this valuable asset.

5 Conclusions

5.1 We consider that none of the options proposed in the discussion document can be accepted as an adequate substitute for appeals to the Privy Council. Further work on the court structure that might ultimately replace the Privy Council, including the feasibility of using overseas judges, needs to be undertaken.

5.2 For the immediate future there is no compelling argument for severing appeals to the Privy Council, at least for commercial cases. The 'sovereignty' argument for abolition is emotive and irrelevant.

5.3 There are, however, compelling reasons why abolishing appeals to the Privy Council in the absence of a court system that enjoys high levels of confidence in the local and international commercial community would be damaging to New Zealand business in general.

5.4 Currently the priority task should be to find ways of improving the performance of the New Zealand court system, which is not functioning well on a number of levels. In particular:

- efforts should be made to reduce the cost to the parties of appeals to the Privy Council. The main reducible cost is imposed by the restrictive practices of Privy Council Agents. The authorities in London should be requested to liberalise these rules, including by allowing firms in New Zealand to be appointed as Privy Council Agents;

- the Court of Appeal should drop its current division into two classes of cases and all commercial appeals should be heard by a bench of three Court of Appeal judges. The number of five-judge sittings should be severely reduced and reserved for cases in which the court is being asked to overrule one of its own decisions, as was the case in the past. Court of

Appeal judges would then be available to sit on routine commercial appeals;

- efforts should be made to improve the commercial expertise of the High Court. In this respect, appointments in 2000 and 2001 have been encouraging;

- efforts should be made to improve the calibre and expertise of judges dealing with commercial cases in the District Courts. For the majority of New Zealand businesses, such cases can mean life or death. It is likely that any such effort will have to involve creating a new class of Stipendiary Magistrates to deal with summary criminal cases; and

- there is a strong case for investigating improvements to the nature of the Privy Council appeal right. Such an investigation could usefully explore such matters as access (including a leave requirement, and rolling back of statutory exclusions) and efficiency (including use of electronic media to expedite procedural matters).

5.5 These submissions are made from the point of view of the business community and it may be possible to deal with non-commercial cases in a different way. It must be pointed out, however, that in public law matters the Privy Council currently adopts an attitude of deference to the Court of Appeal and that very few criminal cases go to the Privy Council. Nevertheless, we have not examined issues relating to non-commercial cases in depth, and would not necessarily oppose the abolition of appeals in such cases. If the government wishes to take that step, however, we are strongly of the opinion that the views of the commercial community as the major user of the Privy Council's services should be respected and that appeals should be maintained for commercial cases.

5.6 The debate and decision-making process should not be rushed. The government earlier indicated that no decision would be made in the current parliamentary term. There is no public clamour for abolition. As an important constitutional issue, there should be broad public and political support for any change. Consideration could be given to putting any ultimate proposal to a binding public referendum to be decided on more than a simple majority vote.

Recent Privy Council Cases reported in the *New Zealand Law Reports* and more recent cases

Name of case	Citation	NZ Judges	Subject matter	Result
Manukau City Council v Ports of Auckland Ltd	[2000] 1 NZLR 1	Ld Cooke	Administrative law	Appeal allowed
Tangiora v Wellington District Legal Services Committee	[2000] 1 NZLR 17		Legal aid to Human Rights Cttee	Appeal dismissed
Atkinson v Lange	[2000] 1 NZLR 257	Ld Cooke	Defamation	Remitted to CA
Arklow Investments v Mclean	[2000] 2 NZLR 1	Henry J	Commercial law	Appeal dismissed
Gilrose Finance Ltd v Ellis Gould	[2000] 2 NZLR 129		Commercial/legal system	Appeal dismissed
Phipps v Royal Australasian College of Surgeons	[2000] 2 NZLR 513		Admin law/natural justice/legal system	Appeal allowed in part
Commissioner of Inland Revenue v NZ Forest Research Institute	[2000] 3 NZLR 1	Blanchard J	Tax/statutory construction	Appeal allowed
Auckland Gas Co v Commissioner of Inland Revenue	[2000] 3 NZLR 6	Ld Cooke	Tax	Appeal dismissed
WR Jack Ltd v Fifield	[2000] 3 NZLR 129	Ld Cooke Henry J	Arbitration UNCITRAL	Appeal dismissed
Scales Trading v FESCO	[2001] 1 NZLR 513		Commercial	Appeal allowed
CIR v Auckland Harbour Board	24 January 2001	Ld Cooke	Tax	Appeal dismissed
Dilworth Trust Board v Counties Manukau Health Ltd	7 March 2001	Ld Cooke	Commercial	Appeal dismissed
Contradictors v Public Trustee	8 March 2001		Public Trust assets	Appeal dismissed
Valentines Properties Ltd v Huntco Corporation Ltd	29 March 2001	Elias C J	Commercial	Appeal allowed
O'Neil v CIR	10 April 2001	Elias C J	Tax	Appeal dismissed
Harley v McDonald	10 April 2001	Elias C J	Legal practice	Appeal allowed

PAPER PREPARED BY BRYCE WILKINSON
FOR THE NEW ZEALAND BUSINESS ROUNDTABLE

A MANAGEMENT SCANDAL? INTERPRETING MEASURES OF SHAREHOLDER VALUE

APRIL 2001

Introduction

Statistics produced by Stern Stewart and the ANZ Bank on the destruction of shareholder value by New Zealand companies have attracted widespread publicity. They reinforce widespread anti-business sentiments.[1] One business magazine has interpreted them as a condemnation of "our scandalous management".[2] It has been argued that incompetent management may be a better explanation of New Zealand's inadequate economic performance than poor public policies. These interpretations are mistaken and are unhelpful for the quality of public debate.

The problems arise not because of the statistics themselves but because of a lack of sophisticated appreciation by media commentators and others of their meaning. Consider, for example, three predictable anti-business interpretations of alternative statistical results:

- More than 50 percent of businesses destroy value – media commentators attack businesses for value destruction. None commend them for their achievements in cutting prices relative to costs, or praise the virtues of competition.
- Fifty percent of businesses under-perform, or just produce the required return on capital – media commentators attack businesses for the alleged mediocrity of their performance.
- More than 50 percent of businesses create value – media commentators attack businesses for price-gouging and excessive profits, especially if they are overseas owned. Some call for greater regulation of profits, controls on overseas investment and public ownership of businesses.

All these reactions would be superficial and probably flawed. They do nothing to improve public understanding of business.

This note considers two issues:

- what do the statistics say?; and
- how should they be interpreted?

What do the statistics say?

Companies raise money from shareholders and borrow money from banks and other lenders in order to fund business assets. One measure of whether companies have added value for shareholders is the difference between the current market value of those assets and the total amount of money that has been invested in those assets over the years. Stern Stewart call this statistic market value added (MVA). A second measure, economic value added (EVA), essentially reflects the difference between a company's achieved net operating profit in any given year and the net operating profit

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1 According to a poll reported in the *National Business Review* of 1 December 2000, 71 percent of respondents had a favourable view of Greenpeace and 75 percent thought it was doing a good job. Of the four business-related organisations included in this survey, only Federated Farmers came close to this ranking. For a discussion in an international context of the pattern of distrust for business, and trust in anti-risk and anti-industry activists, see Mark Neal, 'Risk Aversion: The Rise of an Ideology', in *Safe Enough? Managing Risk and Regulation*, edited by Laura Jones, Fraser Institute, 2000.

2 *Unlimited*, March 2001.

it needed to achieve in that year in order to compensate shareholders for the cost of capital.

Significant adjustments may have to be made to a company's published accounts in order to estimate MVA and EVA. For example, past write-offs and lease payments may be treated differently by different analysts. The statistics may vary because of errors or differences in judgments about the proper adjustments to make.

Stern Stewart have published MVA and EVA statistics for New Zealand's largest listed companies for at least the last three years and are an international authority on this methodology.

Stern Stewart's data (see the appendix[3]) can be summarised as follows:

(i) A large majority of companies (83 percent in 2000, 80 percent in 1999 and 76 percent in 1998) have created value, as measured by the MVA.

(ii) The excess for the year 2000 is considerable. Summed over the 40 companies in the 2000 table, MVA exceeded contributed capital of $41,598 million by $16,632 million, or 40 percent.

(iii) These excesses are volatile. In 1998, the excess for 45 companies was only $13,592 million, a 34 percent gain on capital of $40,408 million. In 1999, the excess was $20,164 million on capital of $41,704 million, a 48 percent gain.

(iv) Half the companies in 2000 and in 1999 and 62 percent of companies in 1998 achieved a net operating profit in excess of their cost of capital – that is, had a positive measured EVA.

(v) In each year, the reductions in EVA by the remaining companies outweighed these gains. In 2000, the EVA summed over 40 companies was a negative $1,014 million, up from a negative $768 million in 1999. In 1998, it was a negative $1,207 million (summed over 45 companies).

(vi) The largest losses in EVA were very concentrated. In 2000, three companies, Air New Zealand, Carter Holt Harvey and Fletcher Challenge Forests, had a combined negative EVA of $1,325 million. In 1999, four companies – Carter Holt Harvey, Fletcher Challenge Forests, Fletcher Challenge Paper and Fletcher Challenge Building – recorded a cumulative negative EVA of $1,320 million. In 1998, two companies, Carter Holt Harvey and Fletcher Challenge Paper, had a combined negative EVA of $1,349 million. Both companies are highly exposed to world wood, pulp and paper prices.

How should such statistics be interpreted?

Managers should only be held accountable for risks that they can manage

Share prices are volatile and share investments are risky. Many risks are outside the control of any firm. Examples include changes in technologies, taxes, market interest

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[3] I am grateful to Garth Ireland for his assistance with this information.

rates, exchange rates and world product prices. Firms have some ability to manage some of these risks, but they cannot eliminate all of them.[4]

Sharemarket analysts accept the reality of business risk by analysing the performance of any one management team against more benchmarks than just the cost of capital. Another common benchmark is the performance of teams that are exposed to similar risks. One forestry company's performance would be compared with the performance of other forestry companies, for example. Such comparisons are a commonsense, if imperfect, way of abstracting from the effects of factors that are mainly outside the control of any particular firm.

It makes no sense to blame the performance of New Zealand's forestry-related firms on their management teams independently of any assessment of their performance against international forestry-related competitors.

By the same logic, it makes no sense to accuse non-forestry-related firms of poor management just because forestry has a large enough weight in the New Zealand market to drive the overall market into a negative EVA situation when world forest product prices are depressed.

Competition should force MVA and EVA to zero for the average firm

In a competitive market, shareholders can only expect firms to achieve their cost of capital.[5] Competition from new entrants or new investment by incumbents when industry profitability is above normal levels forces down prices to end users and reduces profitability. Conversely, firms exit until industry profitability is restored when the industry as a whole is failing to cover the cost of capital.

In a steady state, the typical firm will only achieve more or less than the cost of capital by chance. Therefore, the benchmark for assessing performance should be zero MVA and EVA. Abstracting from the business cycle, as many firms can be expected to achieve less than the cost of capital as exceed the cost of capital. The percentages of firms covering the cost of capital as measured by EVA in the three years of Stern Stewart data (50 percent in 2000 and 1999 and 62 percent in 1998) appear to be consistent with the zero excess profit hypothesis.

The substantial excess of measured MVA over the benchmark of zero appears to contradict the zero excess profit hypothesis. As such, it invites further inspection. One possibility is that there have been favourable economy-wide shocks prior to the last three years – leading the average company to achieve returns in excess of the cost of capital. Under this hypothesis overall MVA should be negative in some future period. A second possibility is that the statistics are flattering because of a survivorship bias. Companies that recorded negative MVAs in the past may have disproportionately dropped out of the sample because they have become too small. This effect may well be significant. A third possibility is that the statistics overstate MVAs by understating invested capital.[6] For example, investments in reputation and market positioning may

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4 According to Erik Stern, *Financial Times*, 6 March 2001, academic studies suggest that 70–80 percent of the share price of a company is the result of macroeconomic, industry and other factors that are generally beyond the control of managers.

5 Shareholders are satisfied when the return compensates them for the risk incurred.

6 The converse case is where MVA is persistently negative because past investments need to be written down in value but have not been.

not be recorded accurately in either EVA estimates or in estimates of committed capital. A fourth possibility is that important assets of many large firms are inframarginal in an increasing cost situation. Competition only drives out excess profits at the margin. If a new entrant faces higher costs, for example, because of more stringent environmental or planning legislation or because all the best locations are already taken, incumbents might be able to earn ongoing economic rents measured relative to their invested capital.

The second, third and fourth possibilities provide exceptions to the opening proposition that the benchmark for success should be zero EVA and MVA. As such they suggest reasons for caution in interpreting EVA and MVA statistics. However, they do not negate the basic insight that competition can be expected to eliminate super-normal profits in time.

Note that none of these hypotheses makes any particular assumptions about the quality of management of the average firm.

Shareholders will not keep pouring good money after bad

Even in the absence of competition and in the presence of severe principal/agent problems, shareholders will price the firm so that they can realistically expect to achieve required returns in future. A negative surprise will see shareholders write down the market value of the firm to a level at which future expected returns compensate for risk. Unless those preparing EVA and MVA reports write down the estimated quantum of capital employed in the business, subsequent measures of EVA and MVA will be less positive than they should be on the basis of the capital actually available to managers.

Sharemarkets with poor earnings prospects are characterised by low price-earnings multiples. They are not characterised by chronic under-performance in sharemarket index terms. This is because investors can confidently be expected to learn from their mistakes, revising their assessments of the quality of management teams and boards accordingly.

Furthermore, it is fanciful to suppose that there can be any sudden change in the quality of management amongst listed companies as a whole.

For all these reasons it is implausible that any prolonged period of poor sharemarket returns can be attributed either to a sudden downturn in the quality of management or to undue, chronic optimism about the quality of existing management.

There may be no free lunch for shareholders in hiring higher quality management teams

Shareholders should be able to achieve their required returns on average as long as the managers they employ have the required competencies and their remuneration reflects their productivity. Highly competent managers can be expected to be paid more than less competent managers – but would have to earn commensurately more revenue for shareholders in order to justify their higher remuneration. There is surely a limit to the level of competence that it is economic to employ locally. What would be the point of trying to hire, say, Bill Gates, at his current salary, to come to New Zealand to run a small New Zealand computer company? Markets match horses to courses. Moreover, lack of economies of scale, an unfavourable regulatory environment or a troublesome board might prevent highly competent chief executives from achieving their full productivity. In that case such chief executives can probably be more productive elsewhere.

There is no reason to assume that highly productive managers will produce greater profits for shareholders unless they are exposing shareholders to greater risk.[7] Competition between management teams should ensure no free lunches for management teams, or for shareholders.

While any one firm can expect to raise market share and profitability by raising its performance, the fallacy of composition explains why this will not occur if all its competitors do the same. Competition shifts the benefits to consumers and those who have raised their marginal productivity. One athlete may increase the chance of winning a gold medal by training harder and better, but only if competitors do not follow suit.

Of course, the returns to managers also reflect the assignment of risk between managers and shareholders. Other things being equal, the remuneration of managers should be greater the more insecure and unprotected their tenure.

In the case of weak boards, existing management teams may be able, for a time, to achieve excessive rewards and tenure at the expense of shareholders. Such management teams have an obvious incentive to support measures such as restrictive company takeover regulation or limitations on foreign investment that could protect their positions. Governments that pass such regulations can expect to exacerbate any gaps between rewards and performance.

A final caveat is that productivity is a function of effort and quality. Highly able individuals can exhibit low productivity because of insufficient effort and focus.

None of these caveats alters the basic proposition that competition between management teams should ensure that their cost reflects their productivity. Any serious discussion of the quality of management in New Zealand from an international perspective should start with an analysis of rates of remuneration. Adjustments should be made for risk and effort.

Since rates of remuneration at the top levels of management in New Zealand appear to be vastly lower than in comparable countries, it seems likely that the productivity of top management teams is lower on average than elsewhere. To the degree that they are internationally mobile, this suggests that New Zealand's managers are variously making a life-style choice, accepting markedly lower risk, or are of inferior quality to their overseas counterparts. Alternatively, some may be earning relatively low incomes, despite enormous effort and being of high quality, because of immobility and low productivity. The low productivity could be caused *inter alia* by the lack of economies of scale or an unfavourable tax and regulatory environment. A compensating factor from a national perspective could be overseas ownership of New Zealand operations which benefit from the skills of management teams in parent companies abroad.

Another argument is that managers of some companies in New Zealand are paid badly in the sense that the performance-related element of their remuneration package is too

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7 For the technically minded, this means greater 'priced' risk. Under the idealised assumptions of the Capital Asset Pricing Model, only systematic risk is priced. In reality, some non-systematic risks could be priced as well. Principal/agent risks could be priced.

small. Essentially the critics are saying that these companies can benefit from their advice. If so, they should prove their worth in the market for advisers.

Government regulation and management quality

Government policies can be expected to affect the rate of remuneration of management teams for any given level of productivity. Anti-takeover laws seem more likely to benefit lawyers, investment banks, regulators and poor management teams than shareholders. Regulations that remove privacy concerning remuneration expose top managers to envy and malice, reducing the attractiveness of envy-prone countries as places to work. This factor, in conjunction with the signalling effects of published salary rankings – most firms want employees to think they are paid above market rates, and the job of headhunters is made easier – can be expected to increase rates of remuneration in general, but not the pre-existing level of productivity. Regulations that seek to increase management liability will have similar effects. On the other hand, employment laws that raise the cost of firing insufficiently productive management teams typically benefit incumbent management teams at the expense of competing teams.

Regulations that raise the costs and risks of employing management teams without raising their productivity are like a tax on the hiring of management teams. Such regulations should reduce the demand for management teams until the (higher) productivity of the marginal surviving team balances the costs of hiring it. Regulatory taxes on management teams could have adverse implications for the choice of organisational form and the ability of firms to separate management from control, and, therefore, to access capital markets and achieve economies of scale.

Concluding comments

The populist view that the shareholder value statistics that have recently been published prove that the business community at large has been destroying value out of mediocrity or incompetence is simply erroneous. The major losses in value in the Stern Stewart data relate to three companies, Air New Zealand, Carter Holt Harvey and Fletcher Challenge Forests. Other major losses were incurred by Brierley Investments following its disastrous Mount Charlotte takeover when the company became a victim of inflexible takeover laws. The statistics do not point to under-performance of the average management team.

The view that the overall performance of the New Zealand sharemarket could be improved by a general lift in the quality of management teams simply reflects the fallacy of composition. Competition would transfer the gains to consumers and to those who raised their productivity.

Criticism may fairly be directed at companies that have destroyed value through failures of corporate governance. Also, there is always scope for improving the quality of New Zealand management. No management team is perfect. Management performance is also likely to be influenced by the level and structure of remuneration. Boards have ongoing incentives to review the links between pay and performance in the company sector and to avail themselves of value-creating advice.

The conciliatory or pusillanimous strategy adopted by some of saying 'sure the business sector has blotted its copybook and must do better':

- condones the fallacious interpretation of the statistics and thereby reinforces anti-business prejudices and propaganda; and
- is otiose because people are fallible and some will always be 'blotting their copybooks' in business or in government.

There seems to be no substitute for greater efforts by those who understand the meaning of company performance data to explain them better to those who can communicate effectively with the public at large.

The nature of much media commentary reflects widespread ignorance of the basic concepts discussed in this paper and the strength of anti-business sentiments in New Zealand. The all-too-common use of the shareholder value statistics to dismiss business criticisms of poor public policies is unhelpful to public debate.

Since around 1993, government policy drift and more recent policy reversals have pushed New Zealand towards a path of lower economic growth rather than towards a vigorous, dynamic outward-looking future. Given this outlook, some management teams can be more productive outside New Zealand and some large internationally integrated companies can benefit from relocating their head offices abroad. There is nothing inevitable about such moves, but they should be seen as rational responses to the policy environment.

APPENDIX

The Independent

MVA Rank 2000	1999	Company	MVA $m 2000	MVA $m 1999	MVA Change 1999-00	EVA Sm 2000	Capital Sm 2000	Return on Capital (R)	Cost of Capital (C)	Market to Book (Times)
1	1	Telecom Corpn of New Zealand	10,323	11,534	-1,211	362	7,272	17.6%	11.7%	2.42
2	2	Sky Network Television Limited	1,459	1,141	318	-47	313	-4.8%	12.7%	5.66
3	4	Warehouse Group	1,316	900	416	44	405	24.7%	12.0%	4.25
4	11	Independent Newspapers*	994	350	644	-54	943	6.0%	12.0%	2.05
5	3	Auckland International Airport	842	989	-147	11	514	12.6%	10.4%	2.64
6	13	Baycorp Holdings	825	344	481	7	92	22.3%	13.1%	9.94
7	5	Contact Energy	763	897	-134	-23	1,854	8.9%	10.3%	1.41
8	6	United Networks	611	703	-92	57	1,188	10.6%	7.8%	1.51
9	10	Fletcher Challenge Limited	532	356	176	-65	2,422	11.5%	14.2%	1.22
10	7	Sky City Limited	412	520	-108	12	781	12.6%	10.7%	1.53
11	16	Fisher & Paykel Industries	349	344	5	-4	887	9.4%	9.9%	1.39
12	18	Montana Group	349	897	-548	16	265	16.6%	10.5%	2.32
13	20	Transalta	327	703	-376	-13	681	6.9%	11.7%	1.48
14	9	Ports of Auckland	324	356	-32	18	261	17.6%	10.6%	2.24
15	14	Port of Tauranga	285	520	-235	8	173	13.8%	9.0%	2.64
16	12	Trust Power	234	349	-115	-2	507	8.8%	9.2%	1.46
17	15	Natural Gas Corpn Holdings	189	307	-118	-57	2	6.7%	11.2%	1.11
18	8	Fletcher Challenge Building	187	457	-270	-1	1,434	11.3%	11.4%	1.13
19	17	Waste Management NZ	178	273	-95	-3	223	10.8%	12.7%	1.80
20	23	Ryman Healthcare Limited	132	110	22	6	80	19.6%	9.8%	2.64
21	21	Sanford Limited	126	188	-62	28	308	20.7%	10.4%	1.41
22	22	Lyttleton Port Company	118	122	-4	8	47	27.9%	12.6%	3.52
23	19	NZ Refining	111	213	-102	-10	172	5.8%	11.7%	1.65
24	28	Advantage Group	104	73	31	-1	77	15.8%	17.5%	2.36
25	24	Hallenstein Glasson Holdings	85	104	-19	7	56	23.9%	11.7%	2.51
26	29	Mainfreight Limited	72	67	5	1	97	12.2%	11.2%	1.75
27	33	Ebos Group Limited	67	21	46	2	51	15.0%	10.1%	2.32
28	26	Metropolitan Lifecare	67	80	-13	-6	120	3.2%	8.6%	1.56
29	27	Michael Hill International Limited	66	77	-11	5	87	13.8%	8.4%	1.76
30	25	Restaurant Brands of NZ	61	92	-31	6	105	15.7%	9.4%	1.58
31	30	Cavalier Corporation	38	49	-11	4	117	11.4%	8.5%	1.32
32	31	Tourism Holdings	31	44	-13	5	325	11.8%	9.9%	1.09
33	32	Nuplex	28	41	-13	1	275	10.5%	10.0%	1.10
34	35	Tasman Agriculture	-27	-40	13	-4	245	7.2%	8.9%	0.89
35	34	Steel & Tube Holdings	-29	19	-48	-2	214	9.9%	10.8%	0.87
36	36	Tranz Rail	-52	-68	16	10	796	8.9%	7.8%	0.94
37	38	DB Group	-197	-237	40	-15	495	6.7%	9.6%	0.60
38	39	Fletcher Challenge Forests	-825	-438	-387	-287	2,269	-1.5%	11.8%	0.64
39	40	Carter Holt Harvey	-1,770	-1,213	-557	-839	7,811	1.7%	12.4%	0.77
40	37	Air New Zealand	-2,073	-170	-1,903	-199	7,634	4.6%	8.1%	0.73
		Totals	**16,632**	**21,074**	**-4,442**	**-1,014**	**41,598**	**8.4%**	**10.9%**	**1.40**

Conclusions:		
Companies with MVA>0	33	83%
Common companies increasing MVA	14	35%
Companies with EVA>0	20	50%

In Aggregate (rounding errors)	$m	%
Cost of capital (10.9% on $42bn)	4,514	10.9%
Return on capital (8.4%on $42 bn)	3,503	8.4%
Rounded EVA	**-1,012**	

MVA Rank 1999	1998	Company	MVA $m 1999	MVA $m 1998	MVA Change 1998-99	EVA Sm 1999	Capital Sm 1999	Return on Capital (R)	Cost of Capital (C)	Market to Book (Times)
1	1	Telecom. Corpn of New Zealand	11,512	11,281	231	499	5,132	21.5%	11.1%	3.24
2	3	Sky TV	1,140	823	317	-1	220	12.1%	12.9%	6.18
3	2	Lion Nathan	1,051	1,090	-39	16	2,848	8.7%	8.1%	1.37
4		Auckland International Airport	989			13	496	12.8%	9.7%	3.00
5	6	The Warehouse Group	900	329	571	27	344	19.4%	10.9%	3.62
6		Contact Energy	891			80	1,688	15.3%	9.2%	1.53
7	5	United Networks	703	450	253	-32	1,293	5.4%	9.2%	1.54
8	9	Sky City	520	270	250	17	484	13.5%	9.9%	2.07
9	7	Fletcher Challenge Building	456	318	138	-103	1,336	5.3%	12.9%	1.34
10	4	Ports of Auckland	447	552	-105	8	259	16.1%	12.9%	2.73
11	10	Fernz Corporation	375	237	138	13	994	9.4%	8.0%	1.38
12	8	Independent Newspapers*	350	297	53	-33	889	7.2%	10.9%	1.39
13	19	Trust Power	348	97	251	-2	472	8.2%	8.6%	1.74
14	14	Baycorp Holdings	344	144	200	6	61	24.9%	13.9%	6.62
15	21	Port of Tauranga	315	91	224	6	171	12.9%	9.1%	2.84
16	12	Natural Gas Corpn Holdings	307	197	110	13	781	11.2%	9.7%	1.39
17	15	Fisher & Paykel Industries	273	142	131	-19	811	7.1%	9.6%	1.34
18	16	Waste Management NZ	273	135	138	6	97	15.0%	8.9%	3.81
19		NZ Refining	213			10	156	15.8%	9.4%	2.36
20	13	Transalta	211	147	64	42	694	16.0%	9.4%	1.30
21	18	Sanford	203	101	102	26	235	21.1%	10.1%	1.86
22	20	Port of Lyttleton	122	92	30	6	60	22.8%	13.0%	3.03
23	24	Hallenstein Glasson Holdings	104	45	59	6	51	23.1%	11.6%	3.02
24		Restaurant Brands of NZ	92			2	104	11.6%	9.2%	1.88
25	17	Metropolitan Lifecare	80	114	-34	2	94	13.1%	10.0%	1.85
26	25	Michael Hill Jewellers	76	35	41	3	84	14.0%	10.6%	1.90
27	28	Cavalier Corporation	49	7	42	0	136	9.6%	9.3%	1.36
28	31	Tourism Holdings	44	-33	77	-5	158	6.5%	9.2%	1.28
29	27	Nuplex	39	23	16	-2	234	9.4%	10.1%	1.16
30	26	Owens Group	36	29	7	-1	80	7.6%	9.0%	1.45
31	23	Force	35	53	-18	-4	149	7.1%	10.1%	1.24
32	30	Steel & Tube Holdings	19	-24	43	-18	197	3.9%	12.3%	1.10
33	29	Tasman Agriculture	-40	-16	-24	-2	233	6.3%	7.2%	0.83
34	11	Fletcher Challenge Paper	-59	209	-268	-328	4,348	2.0%	9.0%	0.99
35	22	Tranz Rail	-69	71	-140	-26	1,006	4.6%	7.7%	0.93
36	32	CDL Hotels New Zealand	-78	-111	33	-11	498	4.8%	7.2%	0.84
37	35	Air New Zealand	-218	-962	744	-64	4,140	7.3%	8.9%	0.95
38	33	DB Group	-236	-201	-35	-29	516	4.5%	10.2%	0.54
39	34	Fletcher Challenge Forests	-440	-548	108	-269	2,063	-1.3%	11.3%	0.79
40	36	Carter Holt Harvey	-1,213	-2,305	1,092	-620	8,092	4.0%	11.8%	0.85
		Totals	**20,164**	**13,179**	**4,800**	**-768**	**41,704**	**8.4%**	**10.1%**	**1.48**

* The calculation for Independent Newspapers does not take account of unrealised capital gains of $150m on the company's Sky TV investment accrued in 1999.

Conclusions:		
Companies with MVA>0	32	80%
Common companies increasing MVA	28	78%
Companies with EVA>0	20	50%
In Aggregate (rounding errors)	$m	%
Cost of capital (10.1% on $42bn)	4,219	10.1%
Return on capital (8.4% on $42 bn)	3,518	8.4%
Rounded EVA	**-701**	

MVA Rank 1998	1997	Company	MVA $m 1998	MVA $m 1997	MVA Change 1997-98	EVA Sm 1998	Capital Sm 1998	Return on Capital (R)	Cost of Capital (C)	Market to Book (Times)
I	1	Telecom Corpn of New Zealand	11,277	11,253	24	419	4,880	22.1%	12.6%	3.31
2	5	Lion Nathan	1,090	876	214	-20	2,638	7.7%	8.5%	1.41
3	-	Sky TV	823	-		-5	140	8.7%	12.0%	6.88
4	6	Ports of Auckland	552	668	-116	15	219	20.1%	13.5%	3.52
5	7	United Network	450	646	-196	29	418	16.6%	9.1%	2.08
6	11	Warehouse Group	329	488	-159	13	314	16.2%	12.0%	2.05
7	16	Qest New Zealand	323	348	-25	18	196	21.1%	10.8%	2.65
8	3	Fletcher Challenge Building	316	1,238	-922	16	1,418	12.7%	11.5%	1.22
9	10	Sky City	299	548	-249	3	445	10.5%	9.8%	1.67
10	12	Independent Newspapers	297	479	-182	-13	906	10.0%	11.7%	1.33
11	14	Fernz Corporation	216	376	-160	17	1,023	10.6%	8.7%	1.21
12	4	Fletcher Challenge Paper	202	1,105	-903	-774	5,092	-5.9%	10.3%	1.04
13	15	Natural Gas Corpn Holdings	197	365	-168	42	951	11.3%	6.7%	1.21
14	17	Transalta	147	299	-152	13	600	10.4%	7.9%	1.25
15	25	Baycorp Holdings	144	143	1	4	50	23.4%	14.3%	3.88
16	20	Waste Management NZ	135	204	-69	4	84	14.1%	8.7%	2.61
17	18	Fisher & Paykel Industries	135	242	-107	-12	791	7.2%	8.8%	1.17
18	34	Metropolitan Lifecare	114	66	48	3	52	17.6%	11.7%	3.19
19	35	Sanford	101	56	45	3	248	11.6%	10.3%	1.41
20	21	Trust Power	97	203	-106	12	290	12.0%	7.4%	1.33
21	22	Port of Lyttleton	92	177	-85	6	63	22.7%	13.2%	2.46
22	24	Port of Tauranga	91	144	-53	1	161	8.6%	8.0%	1.57
23	8	Tranz Rail	71	622	-551	23	869	11.9%	8.6%	1.08
24	30	Corporate Investments	61	93	-32	-8	428	9.0%	11.0%	1.14
25	19	Milburn New Zealand	58	208	-150	8	248	13.5%	9.9%	1.23
26	33	Force	53	78	-25	-1	115	7.9%	8.7%	1.46
27	32	Mainfreight	48	82	-34	2	67	14.7%	11.9%	1.72
28	28	Bay of Plenty Electricity	46	108	-62	3	82	13.0%	8.5%	1.56
29	29	Hallenstein Glasson Holdings	45	96	-51	5	47	21.9%	11.8%	1.96
30	37	Michael Hill Jewellers	35	32	3	1	72	13.6%	11.9%	1.49
31	31	Owens Group	29	89	-60	3	112	11.5%	8.9%	1.26
32	26	Nuplex	23	110	-87	-6	236	6.2%	10.3%	1.10
33	27	Progresssive Enterprises	21	108	-87	-32	533	3.0%	8.9%	1.04
34	39	Cavalier Corporation	7	13	-6	1	138	10.2%	9.4%	1.05
35	42	Tasman Agriculture	-16	-10	-6	3	219	8.0%	6.6%	0.93
36	38	PDL	-23	20	-43	4	191	9.2%	6.9%	0.88
37	23	Steel & Tube Holdings	-24	172	-196	-8	222	8.2%	11.7%	0.89
38	41	Tourism Holdings	-33	7	-40	-8	200	4.2%	8.3%	0.84
39	36	Wrightson	-48	40	-88	8	155	10.2%	8.0%	0.69
40	43	Kingsgate International Corp	-80	-27	-53	-15	216	3.9%	11.7%	0.63
41	40	CDL Hotels New Zealand	-111	9	-120	-26	460	5.8%	11.7%	0.76
42	44	DB Group	-201	-86	-115	-32	532	5.1%	11.2%	0.62
43	9	Fletcher Challenge Forests	-552	594	-1,146	-248	2,189	-2.1%	10.7%	0.75
44	13	Air New Zealand	-936	420	-1,356	-103	3,888	6.0%	9.0%	0.76
45	2	Carter Holt Harvey	-2,308	1,622	-3,930	-575	8,210	4.0%	11.8%	0.72
		Totals	**13,592**	**24,324**	**-11,555**	**-1,207**	**40,408**	**7.2%**	**10.5%**	**1.34**
		Conclusions:								
		Companies with MVA>0	34	76%						
		Common companies increasing MVA	6	14%						
		Companies with EVA>0	28	62%						
		In Aggregate (rounding errors)	$m	%						
		Cost of capital (10.5% on $40bn)	4,232	10.5%						
		Return on capital (7.2% on $40 bn)	2,914	7.2%						
		Rounded EVA	**-1,318**							

INSTITUTE OF DIRECTORS
WAIKATO/BAY OF PLENTY BRANCH
ANNUAL GENERAL MEETING

BEYOND THE SOUND AND FURY: GOVERNMENT POLICY, CORPORATE GOVERNANCE AND ECONOMIC PERFORMANCE

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

HAMILTON
27 MARCH 2001

BEYOND THE SOUND AND FURY: GOVERNMENT POLICY, CORPORATE GOVERNANCE AND ECONOMIC PERFORMANCE

I want to take this opportunity to reflect on the respective roles of public policies and business management in national economic performance. Both are vitally important, and there are links between them. But a country is not a company, and economic expertise and the quality of economic management are very different from commercial expertise and the quality of business management. We need to understand the distinctions if we are to avoid muddled thinking.

Modern scholarship into why some countries prosper and others do not goes back over 200 years, but contemporary evidence continues to reinforce its findings. A key lesson is that policies and institutions – such as property rights and the rule of law – matter. The New Zealand Business Roundtable (NZBR) directs most of its efforts to public policies. Organisations like the Institute of Management and the Institute of Directors specialise in management and governance. These are complementary roles.

An easy way to understand the importance of public policies is to contrast the post-war experience of divided countries like East and West Germany or North and South Korea. There was nothing very different about the people or the industrial structures of these countries at the time they were partitioned, yet their subsequent economic fortunes diverged dramatically. In the 1950s, West Germany was described as a free-market economic miracle and from the 1960s South Korea prospered with progressive economic liberalisation. By contrast, the government-dominated economies of East Germany and North Korea stagnated. Not only did material living standards suffer but individual freedoms were suppressed, privilege flourished and the environment was trashed.

More generally, as the world begins the twenty-first century it is clear that better economic performance is associated with greater economic freedom, and that in the leading countries the liberalising trends of the past 20 years are continuing. Just one example: the share of government spending in national income has been falling for several years in most Organisation for Economic Development and Cooperation (OECD) countries – New Zealand is one of the few exceptions. Sounder monetary and fiscal policies, deregulation and privatisation have curbed inflation and helped raise productivity, and much of the world economy has been doing better than at any time since the 1950s and 1960s when similar policies were the norm. These trends in policy and performance have occurred under governments of all political persuasions and seem likely to continue.

In New Zealand, policies moved in a liberalising direction in the mid-1980s and early 1990s, and we saw similar improvements in economic performance. Despite criticisms of the reforms, few people today argue for budget deficits, high inflation, steeply progressive tax rates, industry protection, statutory monopolies or nationalised industries. But from the time of the 1993 election, reform efforts slowed to a crawl and governments ignored warnings that higher government spending would kill the goose that was laying the golden eggs. Recently, policies have shifted in a higher spending and taxing, redistributive and more hands-on direction, contrary to ongoing trends elsewhere.

As the country's economic performance fell back from around 1996, despite temporary ups and downs, one set of debates has been about whether the wrong policies were put in place or whether the problem was that they were not maintained and extended. However, an alternative explanation, put forward, for example, by Brian Gaynor in the *New Zealand Herald* and by *Unlimited* magazine, places the blame on poor business performance – *Unlimited* refers to "our scandalous management". Proponents of this view, which I want to examine, focus on things like the quality of business management, corporate governance, weaknesses in commercial regulation, and the New Zealand sharemarket.

Economics training always makes me cautious about blaming people for systematically poor outcomes, whether a lack of value creation and innovation in business or chronic under-performance in sectors such as health and education. Usually the problem in any dysfunctional sector is the incentives and constraints that people working in it face. It is hard to argue that the managers of businesses in East Germany and North Korea were genetically inferior to those in West Germany and South Korea. Indeed, what these examples suggest is that a good policy and institutional environment creates good managers, and that no amount of talent and effort can compensate for a bad environment.

Having said that, I think there is force to some of the criticisms of business performance. It would be surprising if it were otherwise. New Zealand had to negotiate a difficult transition from an inward-looking and protected business environment to an outward-looking and competitive one. The attributes for business success in old New Zealand were things like contacts with politicians, skills in getting around regulations or using them to advantage, tax planning, the ability to prosper from high inflation, and cunning in dealing with unions. By contrast, the new environment put a premium on skills in leadership, business strategy, meeting consumers' needs, financial management, employee relations, risk taking and innovation. Countries like the United States have had a deep reservoir of such business skills going back many decades, and a culture that values individual and business success. New Zealand lacked these attributes, which are not acquired quickly.

Thus, it was regrettable but not surprising that in an environment of greater economic freedom in the 1980s, some so-called 'entrepreneurs' failed spectacularly, and it was inexcusable that others broke or pushed the limits of the law. But even here, a sense of perspective is necessary: in Australia, where the economy was also being opened up, there were many more spectacular failures and more cases of wrongdoing. Absent wrongdoing, accusations of greed should be directed more at those who put their money into high-risk investments than to those who solicited their funds. And we should not lose sight of the fact that, human nature being what it is, there will always be some poor managers and some rogues, and there will always be some failures, especially in downturns. Just look at the recent Nasdaq meltdown, and the hordes of disgruntled shareholders liberally casting blame around.

Similarly, in the 1990s much has been made of the amount of shareholder wealth that has been destroyed in the corporate sector in New Zealand. There is no doubt that there have been some egregious cases of poor management and poor corporate governance, but the numbers are not large. Again, a number of points need to be made to put the issue in perspective.

First, New Zealand has not had this problem to itself. ANZ Bank research puts the total losses between 1991 and 1999 at around $14 billion. In Australia, BHP alone destroyed more than that amount of shareholder value in recent years, and several other big companies lost large amounts.

Secondly, a failure to cover the cost of capital is by no means confined to the listed company sector. ANZ's research of 500 private companies showed that in 1998 there was a combined loss of value of $6.5 billion, and preliminary indications are that the loss for 1999 was of the same magnitude.

Thirdly, it is not appropriate to consider losses in shareholder wealth without also considering gains. According to Stern Stewart research, a large majority of companies (76 percent in 1998 and 80 percent in 1999) had created value. The largest losses in value have been very concentrated by firm and by sector.

Fourthly, in a competitive market shareholders can expect firms to earn, on average, no more than their cost of capital – that is to say, normal profits. Excess returns will be eroded by competitors, and negative returns will be eliminated by corrective action or firms exiting the industry. The benchmark for assessing performance should therefore be a zero change in value. Spectacular out-performance – as has been the case with a few New Zealand corporates – is no more probable than spectacular under-performance.

Finally, the effect on the economy overall of the large losses in value by a handful of New Zealand corporates is quite small. New Zealand is not an economy of big companies. The 50 or so member companies of the NZBR probably account for only around 10 percent of gross domestic product (GDP). The merger of BHP and Billiton will result in a company with a market capitalisation greater than the entire New Zealand sharemarket. Obviously under-performance by a small number of New Zealand corporates can only have a minor impact on economic growth.

I conclude from all this that the idea that poor business management has been a major factor in poor national economic performance is simply erroneous. Business journalists, trade union officials and others who make this claim are free to put their money where their mouth is and go into business to compete with existing firms or take them over if they think they can do a better job. Business is about risk-taking which involves profits *and* losses; the fact that losses occur is not an indictment of business or business people. An absence of losses would almost certainly mean too little risk taking and innovation was occurring.

None of this is to defend the major management and corporate governance failures that the critics rightly point to, or to express complacency. The relevant question, however, is what can be done about such problems.

The short answer is that there are not many positive things that policy can do to improve business management. Governments can create a competitive environment, they should put effort into upgrading formal education at all levels, and they should strive to make their economies attractive for talented people to work in. Moderate taxes are important here. Foreign investment should be welcomed since it brings with it new practices and management skills. But governments cannot directly foster the skills of entrepreneurship and an entrepreneurial culture. Entrepreneurship is primarily a matter of learning by doing, and developing a deep reservoir of business skills takes a country a long time.

One issue that the New Zealand culture still finds it hard to come to terms with is high salaries for top business talent. I have learned from first-hand experience on the boards of the Electricity Corporation in New Zealand and Colonial in Australia the phenomenal difference that a world-class chief executive makes. Roderick Deane and Peter Smedley were worth their weight in gold to those companies. Top executives get paid large amounts not because they can dictate their own salary but because boards understand their value to shareholders and seek to recruit and retain them. The cost of even a large salary package is a tiny fraction of the total costs of a firm. Large Australian companies like Telstra, Westpac, Coles Myer, AMP and recently BHP have had to go to the United States for chief executives and pay US-type salaries – and not all of these initiatives have been successful. Average CEO packages in New Zealand are less-than-half of those in Australia and one-fifth of those in the United States. In an international market for highly mobile executive talent it seems unlikely that with such large pay differentials New Zealand will generally obtain top quality management teams. On the other hand, one of the consequences of the much-maligned branch economy trend is that New Zealand operations of overseas firms will benefit from management quality at the top of the parent companies.

Others have made the point that not only are New Zealand top executives badly paid; they are also paid badly. There seems to be a weak link between pay and performance. I have a good deal of sympathy with complaints that executive pay and increases in directors' fees in some New Zealand companies have borne no relationship to shareholder interests. Provided media commentators and shareholder activists appreciate the reality that high rewards are usually needed to acquire top talent, I applaud their efforts to hold companies accountable for shortcomings in performance.

I suggested that governments cannot do a lot directly to improve business performance, but they can certainly make the job more difficult. Regulations that remove privacy of salary information expose top managers to envy and malice, reducing the attractiveness of envy-prone countries as places to work. They also have a ratchet effect on pay by making relativity comparisons easier. Regulations that make it difficult to fire non-performing executives except at great cost are damaging to shareholder interests. So too are restrictive takeover regulations that protect poorly performing boards and managements from the threat of takeover. Excessive statutory duties and liabilities imposed on directors foster defensive behaviour and a culture of compliance rather than performance. We have seen the introduction of ill-conceived regulations in all these areas in recent years in New Zealand.

Much misinformed commentary has drawn links between alleged inadequacies in New Zealand management, New Zealand's overall growth performance, the performance of the New Zealand sharemarket, and sharemarket regulation. This heaps confusion upon confusion.

People point out, for example, that in 1994 the NZSE Top 40 Capital Index was around 2000, more or less at level pegging with the Australian All Ordinaries index. They go on to observe that our index is still around the 2000 mark whereas the All Ordinaries is around 3200, and suggest this is due to better market regulation in Australia.

This reasoning is absurd. In 1994, the Dow Jones Industrial Average index was around 3600 whereas it is around 10,000 today. The US sharemarket has vastly outperformed Australia's, yet no one would suggest the difference is due to different market regulation. (Moreover, any proper comparison should focus on gross returns – dividends plus capital appreciation. The NZSE Top 40 Gross Index has risen from around 2000 in 1994 to around 2600 today.)

Sharemarkets are driven by company earnings – or more precisely expected earnings – which in turn are powerfully related to national economic performance. The performance of the New Zealand sharemarket matched that of other sharemarkets in the early to mid-1990s when economic growth was strong, and fell away as our economic performance deteriorated. Likewise Japan's sharemarket is currently at a 16-year low – one-third of its level in 1989 – reflecting that country's deep economic troubles. No one would seriously suggest that those running Japanese firms suddenly lost their skills – the prime factor is a decade of government mismanagement.

Arguments that New Zealand's market regulation is inadequate or out of line with that of other countries are wide of the mark. With respect to takeovers, for example, the recent Kirin and Montana transactions that caused so much sound and fury would have been entirely permissible in the United States, the world's leading securities market. The mandatory bid and equal price provisions of the Takeovers Code that the government is introducing would not apply to similar transactions in the United States, or Japan either for that matter. No one has explained why a one-size-fits-all rule should be imposed on all companies, and why shareholders should be denied the freedom to determine their own rules. With a few exceptions, such as an editorial in the *National Business Review* and an article by John Roughan in the *New Zealand Herald*, editorialists and reporters completely missed these basic points in the recent hysteria. Yet time and again leading academics and professionals have raised principled objections to more heavy-handed takeover regulation, and inquiries have pointed to problems of enforcement rather than the law. It remains to be seen whether there were shortcomings in enforcement in the Montana case.

There has also been much sound and fury over insider trading in New Zealand. However, all my business experience and the advice of experienced people whom I have consulted suggest that serious cases of insider trading are few and far between. Companies and sharebroking firms have meticulous procedures for avoidance of insider trading, mechanisms for detecting it and education programmes for staff. One New Zealand company chairman who has probably had more contact with offshore investors in recent years than any other confirmed to me that the issue has never been raised with him. In his words, the idea that tougher regulations on takeovers and insider trading and a more heavy-handed Commerce Act "will somehow vastly increase share prices is, unfortunately, a complete myth".

New Zealand's insider trading law is poorly conceived: it was a botched response to the 1987 sharemarket crash. Nevertheless, in this area as well, the main problem may be enforcement. The legislation provides for shareholder remedies. Having become sick and tired of columnists and others complaining about insider trading and doing nothing about it (apart from calling for more regulation), I joined in an insider trading action last year following a damning Securities Commission report. I have learned in the process that doing so is not onerous or costly. Regardless of the outcome of this and other cases, there is a need for better insider trading law focused on the central issue that is the misuse of company property. Unfortunately, this is not the focus of the government's current review.

In summary, I suggest that claims of inadequate market regulation and business misconduct have little foundation as explanations of poor sharemarket and national economic performance. Personal experience and survey evidence suggest that, overall, New Zealand scores well relative to other countries for transparency and integrity in business. Unsubstantiated claims of 'wild west' behaviour coming from politicians or others with an axe to grind are irresponsible, and business people and regulators should stand up and say so.

The quality of business management and New Zealand attitudes to business and entrepreneurial success are certainly relevant factors. However, business has been on a steep learning curve and many able managers and entrepreneurs are coming through. Governments cannot do a lot directly to accelerate this process, although they can remove obstacles to better corporate governance. Business people themselves must strive to improve management and corporate governance performance. With competitive capital markets and no barriers to entry into industries, there is only limited scope for sustained under-performance. The availability of managerial talent could become a more serious factor, however, if the present outflow of highly skilled people is not soon arrested.

I conclude that the most powerful factor affecting national economic performance is, therefore, the quality of the economic framework within which business operates. The late Mancur Olson, author of *The Rise and Decline of Nations*, wrote that the best thing a society can do to increase its prosperity is to "wise up" in respect of its policies and institutions. New Zealand has lost ground in this regard, and current directions are at variance with those of more successful countries. The government's more recent emphasis on economic growth and issues such as business compliance costs is welcome. The reality, however, is that many of its own measures such as the widening of the tax scale, the retention of tariffs, more complex employment law and increased regulation of electricity, telecommunications and takeovers have all increased business compliance costs. No credible overall economic strategy to achieve a better economic performance has yet been articulated.

Currently there are some bright spots in the economy, but also some persistent weaknesses as well as threats on the international horizon. In the year to 31 March 2001, economic growth is likely to come in at somewhere between 2 and 3 percent, well below the government's expectations of 3.7 percent in the 2000 Budget Policy Statement. Despite recent favourable conditions the outlook for the year to March 2002 is likely to be in a similar range, and again below the same estimate of 3.7 percent in the 2001 Budget Policy Statement. I would be surprised if the Treasury or the Reserve Bank believed New Zealand's sustainable growth rate is now higher than 2–3 percent with current policy settings. The idea that this constitutes "an extremely rosy picture for New Zealand", as Terry Hall suggested recently in *The Dominion*, is bizarre. It is a recipe for New Zealand continuing to lose ground relative to leading countries. Pointing this out is not always a popular occupation. However, those of us in business must continue to debate the central issue of economic policy directions if we want a better business environment and a better economic future for New Zealand.

WHANGAREI BUSINESS AND PROFESSIONAL COMMUNITY

PROFITS OR PEOPLE: A BOGUS DILEMMA

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WHANGAREI
15 DECEMBER 2000

PROFITS OR PEOPLE: A BOGUS DILEMMA

This talk is dedicated to John Campbell. Most Saturday mornings, on Radio New Zealand, John instructs his listeners, in his very amiable style, about the evils of profits. A self-confessed "liberal leftie", he tells us that people should come before profits. During the week he fronts *3 News* with Carol Hirschfeld, whose wish is to see "an end to global capitalism".[1] Such perspectives are not unknown elsewhere in the news media. Given the importance of the media for public understanding, they help explain why New Zealand is not achieving the economic success of other countries and why too many people are struggling.

There are some initial ironies here. The only alternative to some form of profit-oriented capitalism is some form of socialism. For some people the fall of the Berlin Wall and the collapse of the Soviet Union still do not seem a sufficient demonstration that socialism has been always impoverishing, variously repressive and sometimes murderous wherever it has been tried. Secondly, John and Carol both work for TV3. Its owner, CanWest, is a foreign privately owned company – an example of 'global capitalism' – and if it does not make adequate profits they will not have jobs. Thirdly, if media reports are accurate, television presenters seem to be at least as interested in their incomes as most entrepreneurs; certainly their pay rates do not appear to violate the minimum wage.

Some people think that profits are wrong because they introduce a commercial orientation. But television presenters, academics and even most members of the clergy work for money in return for services rendered. Doctors and dentists and other professionals running their own practices are even more obviously commercially oriented. None of these people generally work for free. Most would rather have higher pay than lower pay. We do not seem to have a problem about people benefiting from their human capital. Why should we have a problem about them benefiting from their financial capital?

Of course money and profits are not supreme measures of value. They are but means to an end, which is human welfare broadly conceived. No economist that I am aware of would assert that welfare can be adequately expressed by monetary measures alone. We all have other goals in life. The average person in employment only spends about 20 percent of their time at their job – at an income-earning pursuit. Nevertheless, material welfare is important to most people. We cannot be genuinely concerned about poverty if we are not concerned about what makes for material welfare.

It also needs to be said that the policy regime that most reliably links economic activity to human welfare is one that maximises economic freedom rather than gross domestic product (GDP). In the great majority of circumstances, individuals are the best judges of their own welfare and should therefore be left free to make choices in the light of their judgments. Because most people care about their material living standards, economic freedom is very likely to lead to higher incomes and economic growth as they work to get ahead – as indeed a great deal of research confirms. But some people are not especially interested in money, at least beyond a certain amount, and many others at some point will trade off higher incomes for more leisure or some other goal. Provided they do not expect other people to support their lifestyles, they should be perfectly free to do so.

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1 *Sunday Star-Times*, 26 December 1999.

Economic growth, as expressed in changes in the volume of goods and services produced in an economy, is widely taken to indicate that human welfare is increasing. But we need to be aware of qualifications to this proposition. It is easy to think of ways in which public policy could force up economic growth but curtail economic freedom and reduce welfare. The Soviet Union, for example, recorded rapid growth in the 1930s but it was achieved by the forced collectivisation of agriculture and an artificial expansion of heavy industry. The result was a disaster for the Russian people, one from which they have still not recovered.

Similarly, some people believe a compulsory retirement savings scheme would increase national savings and economic growth. However, it would obviously reduce consumption opportunities of low-income people in particular, and alter many decisions that would have been made differently in circumstances of greater economic freedom. This would be welfare-reducing. Governments could no doubt increase output, incomes and economic growth by legislating for a 60-hour week. Would we regard this as an improvement in living standards? There is also the obvious point that development can occur at the expense of the environment, and reduce rather than improve the overall quality of life.

Even where welfare can be expressed in monetary terms, it does not follow that only the profit motive can produce it. The non-profit motive has always been important in health, education, welfare and other personal services. A New Zealand Business Roundtable (NZBR) publication *From Welfare State to Civil Society* by David Green advocates moves away from state provision of a range of social services and greater reliance on a re-invigorated 'civil society' in which voluntary activities flourish. There is strong evidence that charitable associations relying on voluntary donations can do a much better job than the state in tackling many of the symptoms and causes of poverty. Green argues that they must be allowed far greater scope to do so if we are to achieve the more compassionate and public-spirited society that most of us want.

There are many other types of non-profit organisation. Great universities like Harvard and Stanford are not-for-profit. In some cases, the distinction between for-profit and not-for-profit organisations is not large. Non-profits must be able to achieve operating surpluses to service their borrowings and help finance their assets. The main difference is that they do not pay dividends on equity capital.

Nevertheless, most of the goods and services that people value for their material welfare are produced by the commercial, profit-driven sector. In search of profits, Bill Gates and Microsoft have improved the lives of millions of people on earth. Under free and fair competition and the rule of law, self-interest is a positive force because in order to benefit ourselves, we must benefit others. Voluntary market exchanges driven by people's perceptions of their own interests benefit all parties to a transaction. Hence Adam Smith's famous remark that we rely on the self-interest of the butcher, the brewer or the baker to meet our needs, not on their benevolence.

However, it does not follow that profit is always an accurate measure of the contribution of the commercial sector to the well-being of the community. On the contrary: high profits may, for example, reflect government privileges and low profits may reflect poor protection of property rights. A firm that is protected from competition by its rivals, whether domestic or foreign, can increase its profits by producing less and charging more. Competition, in contrast, limits profits by forcing firms that want to survive to offer consumers better or cheaper products. The NZBR has consistently advocated the extension of competition, including where this would reduce the profits earned by private monopolies. Of course, globalisation – the operation of competition in the international sphere – is sometimes attacked by opponents of economic freedom as giving free rein to multinational corporations. That the same people can welcome import protection, which enables local firms, often owned by multinational corporations, to exploit consumers with higher prices and profits, is one of the great mysteries and ironies in the economic policy debate.

Business people are also driven by all manner of visions and ideals beyond short-term profits. Take the great American entrepreneurs of the nineteenth and early twentieth centuries, like Rockefeller, Frick and Huntington. These men were motivated by the need to prove that certain things that had never been done were possible, or by the desire to promote philanthropy or foster the arts. They have left behind famous foundations devoted to these goals. I suspect that many entrepreneurs who start up businesses and innovate are likewise motivated by things beyond profit: by a desire for independence or adventure, or by curiosity, or by a simple need to express their creative urges.

It is true that the typical publicly listed corporation, whose managers are closely scrutinised by anonymous shareholders, has to keep a careful watch on its bottom line. This is exactly how it should be: often tens of thousands of small shareholders have entrusted their money to such firms, either directly or through investment or superannuation funds, and they depend on returns on their savings for their retirement and other needs. Those running public companies are not entitled to play Father Christmas with other people's money. The reality of commercial life is that sometimes a firm has to close operations and lay off staff in order to survive; sometimes negligence or bad luck results in a defective or dangerous product being sold; sometimes changing market conditions oblige a firm to raise its prices. It is then that we are likely to hear the complaint that companies 'put profits before people'.

But 'profits or people' is one of those bogus dilemmas that are invoked in public debate to score easy but erroneous rhetorical points. If a firm makes sustained losses it goes out of business. People that put money into it lose their savings and people working for it lose their jobs. But the deep and venerable prejudice against profit, based on the conviction that a firm can make profits only if others lose, persists even among people who recognise that there is no viable alternative to private enterprise.

For example, the author of a letter to the *New Zealand Herald* last year argued that the profits of the self-employed and of small businesses were 'nearly' the equivalent of wages (and hence presumably justified), whereas medium-to-large corporations "can be monopolistic, self-serving entities with no obligation to the country they reside in, its environment or its future". The author went on to argue that Telecom's profit of $830 million could provide for nearly 2.2 million children in developing countries for a year. It is odd that someone who accepts that small businesses have to make profits can believe that profits are optional for big businesses. The correspondent made no attempt to work out if the achieved rate of profit exceeded Telecom's cost of capital; a total profit of $830 million was self-evidently unfair. Nor was there any recognition of the fact that many of those who own shares in Telecom are poorer than many people who have put their money into their own businesses.

Profit is the difference between a firm's revenue or gross income and its costs, including interest paid on borrowings. It is the residual accruing to the firm's owners. It is a small margin – typically profit before tax accounts for about 8.5 cents of every dollar of gross income. From an economic perspective, the return on equity capital, like interest on debt, is a cost of production – the opportunity cost of not using the capital elsewhere. If the achieved profit is less than the return that could have been achieved from other investments, society is worse off. Investments that just produce the required return are said to produce normal profits.

Profit performs two main functions. First, whether or not a business earns a normal profit indicates whether resources are being efficiently allocated – whether the business is creating wealth or destroying it. This is true under any kind of economic regime – whether capitalist or socialist. If firms do not achieve normal profits on a sustained basis they are failing their shareholders. They may be in the wrong line of business, they may be poorly managed, or the market may have moved against them. Sustained losses are an indication that society would be better off if the firm's resources were reallocated to other uses or taken over by other managers. Subsidising loss-making firms to keep them going is the road to ruin. If we care about people we should beat up on loss-makers not profit-makers.

Secondly, profit plays a crucial role in what has been called the 'discovery process' of the market. The expectation of a favourable profit guides the central decisions that have to be made in any economy: what to produce, how much and at what price. Entrepreneurial profit provides the necessary reward for successful innovation. Most new products fail the test of the marketplace. Those that succeed earn profits that may be temporarily high until other producers enter the market, expand the supply or offer competing products, and bring down profits to normal levels. Often complaints are made about 'excess' profits, but in a market economy they serve an essential function. High profits reflect the greatest gap between what consumers value and what the market was hitherto producing. The hope of temporarily high profits spurs entrepreneurs to accept the risks involved in innovation; without them, innovation would largely dry up.

Consumers benefit from this process. The personal computer is a good illustration. When they came on the market about 20 years ago, personal computers cost several thousand dollars. Fierce competition forced suppliers to cut costs and produce new and better products in never-ending cycles to stay profitable. Now, some Internet service providers are giving personal computers away with e-mail subscriptions. Without profits, new consumer needs would never be satisfied or even discovered.

Of course, business people engaged in their day-to-day activities are not necessarily mindful of the economic (as opposed to the commercial) functions of profit. They are concerned with making the returns they need to stay afloat. But the profit motive is benign so long as it operates under conditions of fair and open competition – within a sound legal and ethical framework, including laws that prevent harm to others and the environment. Where competition exists, no producer can increase profits by charging more than a competitor, since this will mean a loss of sales. Instead, profits can only be increased by giving consumers better value. Market competition disciplines tendencies towards exploitation and greed far more effectively than the institutions of a socialist system.

In competitive markets businesses have to strive ceaselessly to meet consumers' changing needs. But it is here that much of the friction between the profit motive and community expectations arises. Sometimes firms have to put up prices, for example, because the costs of their raw materials have gone up, to stay profitable. Sometimes they have to close operations or replace workers with machines. 'Downsizing' is one of the commonest cases of firms allegedly 'putting profits before people'. However, no one would sensibly describe the expansion or 'upsizing' of a firm as putting people before profits! Consider the alternatives: a firm that fails to adjust will go out of business altogether, thus throwing its entire workforce out of their jobs. Lots of small investors in the firm will lose their savings. The firm's profits belong to people too – in public companies they typically belong to thousands of small investors, not to a few wealthy people. So, the debate is really about whether their property – their hard-earned savings – should be sacrificed in favour of other stakeholders in the firm. Investors surely have the same rights to withdraw their capital as workers have to quit their jobs. They have other investment alternatives, just as workers have other employment opportunities in a well-functioning and tight labour market.

Contrary to old-fashioned notions of class warfare, investors and employees have a common interest in the profitability of their firms and the business sector as a whole. This interest has become stronger as more workers have become shareholders and as capital markets have widened with the demutualisation of insurance companies, public listings of cooperatives and privatisation of government-owned businesses. Already around 52 percent of Americans and 44 percent of New Zealanders own shares, either directly or through vehicles such as unit trusts or superannuation funds. The more people acquire direct stakes in profits, and the more valuable those stakes become, the more irrelevant will the 'profits or people' catchcry seem.

Changes like the spread of share ownership give me confidence that the ancient superstitions about profits will fade away. A generation is coming to prominence (sometimes referred to as Generation X) that has grown to maturity in a world in which the private sector plays a much greater role than it did when their baby-boomer parents were growing up. It has been said that if the reigning ideas in a society change, it is not because anyone has changed their minds but because established generations retire and new generations with new ideas replace them. Only occasionally do we hear from those in younger age groups, as with the recent 'Generation Lost' advertisement. Normally it seems they are busy working to become independent and self-reliant and do not want to get involved in politics. Most want to work for private businesses or start their own, not work in the public sector. They understand that a profitable and successful business sector is the foundation not just of their own personal welfare but that of the poorest in the community. They are distrustful of governments, politics and socialistic solutions.

Thus I would like to conclude by challenging John Campbell, on air, to consider the issue of 'power versus people'. If the profit motive drives business people, the power motive surely drives politicians. We have seen this not just in totalitarian regimes but also in liberal democracies where governments have abused their powers and sacrificed the interests of the people to their own. A lesser role for profits and the market means a greater role for politicians and state power. Those who wish to end global capitalism must be aware that they are promoting bigger government. We need governments to perform important roles. But, if there is one lesson the twentieth century taught us, I suggest it is that people's interests are better served by less government and by more market-based wealth creation in conditions of economic freedom. Will John Campbell rise to this challenge?

VICTORIA UNIVERSITY OF WELLINGTON
COUNCIL CHAMBER

IDENTITY, CULTURE AND SOCIETY

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WELLINGTON
28 NOVEMBER 2000

IDENTITY, CULTURE AND SOCIETY

Introduction

New Zealand's national identity, its cultural heritage and its society are topical issues. According to government spokespeople, they raise problems that need to be addressed. In this lecture I want to examine ideas that are being advanced, see where they might take us, and offer some alternative thoughts.

We were reminded of the importance of these issues last month by the former Russian prime minister Dr Yegor Gaidar in the lectures he gave in Auckland and Wellington as a guest of the New Zealand Business Roundtable (NZBR). He spoke about Russia's traumatic transition from a heavily controlled socialist economy to a market economy. The vast web of central controls suddenly collapsed, but the traditions and institutions necessary for the working of a market economy and a civil society were lacking. Individuals and organisations suddenly had to make decisions on many matters formerly made by the state, but without the necessary cultural capital.

In New Zealand, and I suspect in Western democracies generally, we take many of our institutions for granted. In fact, we often take them so much for granted that we are in danger of throwing them away. We have a well-established rule of law. In commerce we have widely accepted, unwritten ethical codes without which business could not operate, or only at much greater expense. Only a tiny percentage of disputes have to be resolved by the courts. We have considerable freedom to pursue our own interests – commercial, religious, sporting and cultural – with whom, wherever and whenever we like.

But I also think that, over the last 20 years or so, New Zealand has been going through a transition not unlike the one that Russia is experiencing. We only have to reflect for a moment on the enormous range of government interventions that affected both our private lives and our commercial life just a decade or so ago. Because we did have legal and other institutional traditions we have been able to effect the transition more smoothly. However, even in our case, the transition to a freer civil society is far from complete, and some recent legislation, the Human Rights Act 1993 for example, may have taken us backwards in certain respects. There are substantial areas of our society – school education is an obvious example – in which there has been very little transition at all. In schooling, the state and the educational establishment rule supreme, and parents have little ability to choose what is best for their children.

Our commercial traditions are inextricably linked with the rest of the social fabric. For a start, commercial success makes much else possible – and, conversely, the absence of commercial success greatly limits what else can be enjoyed. More than that, a sound economy is essential to our ability to help those who, for whatever reason, cannot look after their own needs.

A successful commercial sector is not always a prerequisite to the sort of cultural activities we describe as 'high' or 'popular' – the Bolshoi ballet and Georgian dance survived in the Soviet Union despite a crumbling economy. Nor, of course, do high material living standards necessarily lead to high culture – that often depends on the chance emergence of genius. But a wealthy society allows patronage of the arts and enables many people to make a living from the practice of their art. High disposable incomes create demand for CDs, books, admission tickets and such like that allow mass access to cultural activities so they are no longer the preserve of the privileged, as they used to be.

With these thoughts in mind, I want to turn to some recent statements by prominent New Zealanders about identity, culture and society.

Our attorney-general and minister in charge of treaty negotiations, Margaret Wilson, in her maiden speech in February this year, said:

> I am one who believes the time has come to bring our constitutional arrangements into line with our growing sense of identity as a people who owe much to many cultures, but who are forging a unique culture that can stand proudly alone. … Maybe the time has come for us to commit to each other as one nation representing many people and cultures without relying on the forms and symbols of a country that is associated with a colonial past, that some of us struggle to move beyond. … I feel a sense of obligation to carry on my ancestors' dream of creating a new society founded on the principles of equality, independence, social, economic and cultural justice.

Another minister, Trevor Mallard, has been expressing similar thoughts. For example:

> [One of the government's] key goals [is] to strengthen National Identity and uphold the principles of the Treaty of Waitangi. We must celebrate our identity in the world as people who support and defend freedom and fairness, who enjoy arts, music, movement and sport, and who value our cultural heritage.[1]

What is noteworthy in these statements is the use of the collective pronouns 'us', 'our' and 'we'. They assume that we all act together in some way in forming a single identity and a common culture and society. That "to commit to each other" suggests some sort of national project – perhaps a cultural version of 'think big'. This could only be determined, ultimately, by a political elite. Such collectivist notions worry me. How could we "commit to each other" in any realistic sense? There are, after all, some 3.8 million of us. I am reminded of the stories, no doubt apocryphal, of film stars giving parties for their thousand 'closest friends'.

It is also not clear to me what relevance the Treaty of Waitangi has in this context beyond its enduring legacy of having made us all citizens of one nation – "all one people", in the words attributed to Hobson – and equal before the law. We might also wonder to what extent New Zealand's cultural heritage and national identity, as affirmed by Mr Mallard, rely precisely on the "forms and symbols" that Ms Wilson would have us discard as redundant and holding us back from achieving our "growing sense of identity".

But at least Ms Wilson and Mr Mallard are raising important issues.

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[1] Trevor Mallard (2000), 'Complying with the new Government's priorities and plans for improving public sector performance and accountability', speech to the Public Sector Performance Conference, Wellington, 3 May.

National identity

Let us start with the issue of national identity. Clearly the government has some role in establishing and maintaining the symbols and structure of nationhood. Yet I must admit to being suspicious of any government that wishes to impose *a* 'national identity'. What, in any case, does 'identity' mean in this context?

The New Zealand-born political philosopher Kenneth Minogue has pointed out that each of us has a separate identity consisting of recognisable characteristics that are consistent over time.[2] If it were not so we would be like the ants or the bees, and inter-personal dealings would be impossible. Those who lack such stable characteristics often end up being institutionalised.

What is this separate individual identity? My answer, like Minogue's, would be that people's identity is tied up very much with what and with whom they identify and feel comfortable. In New Zealand we associate with various groups with whom we have an affinity. I think Maori culture is a genuine national taonga. When I am overseas I usually – but not always – find a particular rapport with other New Zealanders I come across. New Zealanders have the privilege of enjoying the great Western cultural traditions, especially those of Britain. Being French speaking, I feel particularly at ease in France. But I also feel increasingly comfortable in China – I have visited China many times in recent years and have begun to understand a little of its people and cultures. As a history graduate, I have maintained a lifelong interest in history – Russian history is a special interest.

However, the things with which individuals identify are much wider than this. In an open society our education, reading and viewing take us far and wide in time, space and imagination. In history we seek to understand kings and commoners, landlords and peasants, conquerors and native peoples. In novels, films and plays we have no difficulty identifying with a world of wizards and witches, of a land inhabited by hobbits and other strange creatures, of gods and goddesses, of extra-terrestrials, of animals that talk, of dragons and dragon-slayers, and of Georgian ladies and gentlemen seeking suitable husbands for their daughters.

Identity, understood in this way, emphasises not our ethnicity or background but what each of us admires, identifies with, and condemns. The fact of British ancestry does not mean we cannot admire the courage and self-sacrifice of the Maori battalion in the Second World War; likewise Maori can, like the rest of us, identify with the Magna Carta, Shakespeare and Churchill's wartime appeals. An Iraqi refugee to New Zealand may identify with the All Blacks, a Vietnamese refugee with parliamentary democracy or Team New Zealand. We are all horrified at what took place in the Nazi concentration camps, in the gulags and on the killing fields of Cambodia and Rwanda.

Ultimately identity is personal, and that is one reason why I am suspicious of attempts to impose some sort of national identity selected and shaped by political elites. In the hands of government, education, if seen in this light, can become a tool for the indoctrination of the young and a vehicle for social engineering. The notion of an educational elite deciding whether New Zealand's national identity should be based on rugged individualism, politically correct uniformity, or whatever, is ridiculous and unacceptable. Surely the purpose of education in an open society should not be to

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[2] Kenneth Minogue (1996), 'European Identity', paper for School Curriculum and Assessment Conference on Curriculum, Culture and Society, London, February.

impart a particular national identity. Rather it should give children the resources of intellect and imagination that emancipate them from the narrow parochialism of their immediate society and environment and open up possibilities and vistas of which they would otherwise have no comprehension. Education at its best universalises and inducts us into a world of human beings, not into being Maori or European, male or female, New Zealander or from the Pacific Islands.

If identity is ultimately personal, is there any sense in which it can be said that New Zealanders as a whole have a national identity? At the recent constitutional conference, the historian Bill Oliver remarked that New Zealanders had been searching for a national identity for a hundred years, and because they were still searching perhaps it did not exist. But I think we can speak of national identity in a limited sense. Kenneth Minogue has referred to the civil dimension of identity. My identity as a New Zealander is not dependent on my feelings for fellow New Zealanders, which vary considerably, or on sharing a single culture. It is based on common citizenship, on common laws and institutions and upon shared experiences and landscapes. In this modest but important sense we are indeed all partners in upholding a civil society that allows each of us considerable freedom, and our participation in it has nothing at all to do with ethnic origin. As Nelson Mandela has put it in the context of his own country, there are no black South Africans or white South Africans, only South Africans.

Such an approach accepts that national identity is not a common project to be planned and coordinated from the centre. Its outcome is largely spontaneous and unpredictable. It is founded on a civil association of people with multiple goals, not a corporate association with a single goal. It changes as individuals pursue their own interests within the constraints of a shared legal and institutional framework. It is quite at odds with the present emphases on biculturalism and multiculturalism that are not statements about the racial composition of New Zealand but rather government programmes that stress differences for political purposes.

Biculturalism and the Treaty of Waitangi

Biculturalism and the related issue of the Treaty of Waitangi are matters on which the government, or at least some of its members, wish to change popular attitudes. This is an ambition that, like any other form of social engineering, is fraught with dangers.

I would guess that the great majority of New Zealanders agree on the need to remedy established injustices to identifiable property owners, individuals and families. But the rub is who should pay. Taking from the innocent to compensate the victim is not what is usually meant by restitution. The great majority of Maori are descended from those who committed the alleged wrongs as well as from the alleged victims. In such circumstances it would seem that some utopian vision of cosmic justice, to borrow Thomas Sowell's phrase, is driving the process.[3]

Many also have doubts about the justice of making what are sometimes repeat 'full and final' settlements for wrongs suffered generations ago, of claims to new resources such as the airwaves, and of distributions to tribal entities that have decreasing relevance to the everyday lives of the descendents of those wronged. We are in real danger of setting up unrealistic expectations and generating never-ending demands while largely

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3 Thomas Sowell, (1996), *The Quest for Cosmic Justice*, Sir Ronald Trotter Lecture, New Zealand Business Roundtable.

benefiting only the small proportion of Maori and others who are directly involved in what has unfortunately earned the label of the 'grievance industry'.

The present and previous governments' programmes are much more than the settlement of past grievances. The establishment view seems to be that the Treaty of Waitangi established not one people under one sovereign but a partnership between the Crown and Maori. Obviously giving effect to such a view poses real dangers of divisiveness. As the former minister for Treaty of Waitangi negotiations has observed, while the Treaty of Waitangi is *like* a partnership in some respects, it cannot be a partnership since the Crown alone runs the country and represents all New Zealanders, including Maori.[4]

The current bicultural notion transforms the alleged 'partnership' between the Crown and Maori into one between Maori and Pakeha – two distinguishable peoples who form two collectivities in partnership, though the identity of the partners and the nature of their joint enterprise is unclear. Again, this poses dangers of divisiveness. Since the end of the Cooke era, the courts have been backing off the interpretation of the Treaty of Waitangi as a partnership, but this has not been widely recognised outside specialist legal circles, and attempts to give effect to this concept may yet do great mischief.

The idea of partnership, and of the Treaty of Waitangi having principles affecting wide areas of life, has taken deep root in certain circles, especially the education sector. The new school curriculum is explicit: students of social studies, for example, "*will* understand" the nature of biculturalism and the partnership between Maori and Pakeha" (emphasis added). The Tertiary Education Advisory Commission has recently proposed that the tertiary education system should be "reflecting and nurturing a distinctive identity, including greater understanding of the Treaty of Waitangi of Waitangi".[5] This is not, of course, an educational function at all – it is political and ideological. The commission includes several academics, and this *trahison des clercs* shows how far certain elites are prepared to go in trying to subvert education for ideological purposes.

Thus the Treaty of Waitangi, which was to confer equal citizenship on the inhabitants of these islands, is now being used to divide New Zealanders into two separate factions – but yet also mysteriously to unite them in some unidentified common endeavour. It is, as it were, to 'maintain the racial gap' and close it at the same time.

Ms Wilson is reported to want "to develop our attitudes" on Treaty of Waitangi issues.[6] Certainly the government can seek to influence public opinion in all sorts of ways. However, Ms Wilson's commendable concern to counter any "them and us attitude" between Maori and non-Maori sits uncomfortably with biculturalism – a notion that assumes and stresses difference. And does the idea of two cultures really make sense today? Amongst Maori there are varying levels of commitment to traditional tribal organisations and culture, and there are few characteristics that make Maori distinct from the rest of the population. After several generations of living and working in close proximity, this is entirely to be expected and is one of the strengths of the New

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4 Douglas Graham (1997), *Trick or Treaty?*, Institute of Policy Studies, The Printing Press, Wellington.

5 Tertiary Education Advisory Commission (2000), *Shaping a Shared Vision Initial Report*, July.

6 Margaret Wilson as reported in an interview with Anthony Hubbard, *Sunday Star-Times*, 17 September 2000.

Zealand version of the American melting pot. Amongst non-Maori there is a much greater range of languages and cultures including those of Europe, Asia, Africa, the Pacific Islands as well as the British Isles. Many New Zealanders have mixed ancestry.

In creating two 'partners' and in the concept of biculturalism – so-called Maori and Pakeha – the elites seem also to be creating a class of 'non-people' who are neither. The Ministry of Education, one of the keenest, unelected proponents of biculturalism, defines a Pakeha as "A New Zealand-born person of European descent who chooses to be called Pakeha to describe their ethnicity". Those who are not of European descent, or who were not born here, or who otherwise qualify but do not wish to be called 'Pakeha', are not within either 'partner'. This seemingly disenfranchised group would, I judge, be a very significant percentage, perhaps even the majority, of the population. In any case the term 'Pakeha' has become a politically imposed concept, and many do not wish to be categorised in this manner. Many of us identify ourselves as New Zealanders, full stop.

The pursuit of this bicultural vision is likely to be highly detrimental to attempts to attract suitable migrants to New Zealand and to retain them here. It will not help bring able young New Zealanders back from work experience and further education abroad. In a highly mobile world competing for talented people, the prospect of some sort of second class citizenship, just like high tax rates, will be a powerful disincentive.

In any case we should be cautious about deliberate attempts to change attitudes. Not even the Soviet Union, after several generations of 'attitude adjustment', including putting the 'attitudinally maladjusted' in prisons and mental hospitals, was able to stop people thinking for themselves. Indeed the opposite may have happened. The Soviet Union tried to submerge the individual in the collective but succeeded only in eliminating many effective sources of care for others and undermining individual responsibility for providing such assistance. On sensitive and complex issues, not least those of a constitutional nature, the government should basically limit itself to the role of providing reliable and balanced information and allow people time to reflect and come to their own conclusions.

The 'partnership' concept and the undefined principles arising from the Treaty of Waitangi are being applied to, or proposed for, an increasing range of public policy areas such as state educational institutions, health providers, radio stations, social service delivery, local government, health, 'good faith' bargaining, and international trade agreements. The Treaty of Waitangi is developing a life of its own. Far from disappearing once the claims process is completed, the amorphous ideas summed up in the words "the principles of the Treaty" seem set to become a dominant influence upon this country's future development.

It is usual to put major constitutional changes to the people through popular vote. This particular change is being undertaken piecemeal by legislative and administrative action, with important issues being left to judicial decision. Respect for the Treaty of Waitangi as an important part of New Zealand's history is in danger of being undermined by placing on its preamble and three short articles a burden of guiding contemporary society that it cannot possibly support. We need to remind ourselves that while the Treaty of Waitangi is of considerable historical significance, other historical instruments and traditions are of much greater importance to our democratic way of life and constitutional arrangements. Magna Carta, our parliamentary institutions and our common law traditions are obvious examples. We would also do well to remember that in nineteenth-century New Zealand the Bible, not the Treaty of Waitangi, was for many, Maori and non-Maori alike, the main source of authority.

Kenneth Minogue also had something to say about constitutional changes to meet short-term exigencies:

> … no sane people would contemplate reconstituting itself unless it had undergone a crisis … there is little point to [constitutions] unless they are satisfactory if not for eternity, at least for generations ahead.[7]

New Zealand would not do well in this 'sanity' test. Governments have been rearranging our institutions in all sorts of ways – human rights, the electoral system, race relations, the whole Treaty of Waitangi business, and much else. There seems to be a fear among some 'progressive' politicians of being seen as 'anachronistic'. So the right of appeal to the Privy Council is under challenge, and some are urging that we become a republic. I doubt if many of the rest of us are too worried about such 'anachronisms' or even being considered anachronistic. The majority are more likely to be guided by sentimental attachments and loyalties, which *are* important in human affairs, by the need to make a living, and by whether or not current arrangements actually work and promote a cohesive and fulfilling society.

What is more disturbing is the view that constitutional changes, such as those concerning rights, race relations and privacy, will somehow make us better people. "Human beings", Kenneth Minogue dryly remarked, "are much given to seeking salvation, and constitutionalism is one current version of salvation seeking". It has, of course, a certain allure for those who think big, difficult or moral issues should be the business of political elites. In this we are in danger of letting politicians assume ultimate responsibility for everything. In Tzarist Russia this led to a situation in which, according to one historian, the "Russian people tended to accept responsibility for nothing, blaming their own sins and the country's failings exclusively on the empire's rulers".[8] New Zealand risks heading in the same direction.

I do not deny the need from time to time for constitutional change. But I am concerned that it should, in the absence of crises, be unhurried, address some clearly perceived need, be undertaken for the right reasons and after careful thought, and with every expectation that it will endure. To do otherwise is to risk losing what is valuable for some elusive and ephemeral gain.

Multiculturalism

Ms Wilson also said in her maiden speech that New Zealand is one nation, though representing many peoples and cultures, and one in which a single culture is being forged. How should we put all this together? Are there not some contradictions, or at least tensions, here? How, for example, can we or the government promote cultural autonomy, biculturalism and multiculturalism while also insisting we are properly developing a single culture?

In fact the cultural milieu of New Zealand results from the spontaneous decisions of countless individuals and groups. It is constantly changing, and, to the extent it is sensible to talk at all about a single national culture, it is an outcome of people coming

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[7] Kenneth Minogue (1993), *The Constitutional Mania*, Centre for Policy Studies, London.

[8] Dominic Lieven (1993), *Nicholas II Emperor of all the Russias*, Random House, New York.

together naturally on the basis of shared values that relate to future expectations as much as to past experiences.

Nor has traditional Western education ever been monocultural. For centuries school children, from a very early age, have been introduced to the languages and ways of thought of peoples far distant geographically and in time. No tension has been felt in being both a New Zealander and a student of, for example, the languages and cultures of the Greek and Roman empires or of those of modern Europe or Indonesia.

Thus the 'whakapapa' of a Western European is an intellectual one: inquiring and inquisitive.[9] It is open to new ideas and influences. It has drawn on sources from many cultures, races and languages over some three millennia. In traditional tribal societies, culture was essentially closed, authoritarian, hierarchical, and static – but suitable for the world as they understood it to be. This raises a problem for those who see biculturalism as a constructive partnership of Western and *traditional* Maori tribal culture because the two would seem to be incompatible. Maori have long since left a closed tribal structure and are playing their part in modern society. Like members of other ethnic groups, many Maori retain their cultural interests and activities as communal – not public – matters. But it is the biculturalists who want to view Maori culture as static and closed; they must address the difficulties inherent in this view.

Today multiculturalism seeks to treat all cultures equally. At the same time some cultures are to be more equal than others. The entire debate is corrupted by the Orwellian double think that is a characteristic of modern political correctness. The contributions of the West tend to be trivialised or ignored and those of indigenous peoples magnified. Being a member of the majority culture is increasingly portrayed as a matter for guilt. If we identify as Maori then we are victims of oppression and have grievance on our side. This selective and opportunistic morality is fundamentally unhealthy. Moreover, in this process we downgrade the importance of the core traditions and institutions that unite us, including those which Ms Wilson would have us discard as redundant. Politicised multiculturalism emphasises the things that make us different, the things that divide.

As the British columnist Melanie Phillips has said, it is perfectly possible to identify with two cultures: a common civic culture and a private ethnic one.[10] As a British Jew she can speak with some authority. This is what in fact we find in New Zealand. We have a civic 'culture' in the form of constitutional and legal institutions of essentially British origin (though with European, classical and Judeo-Christian antecedents) that apply to all. But all our ethnic, religious and other cultures, indigenous and immigrant, operate within this broad, common civic 'culture' which, I suggest, is essential if we are all to live together in anything approaching harmony. This common framework sets limits on what each individual and group within it can do without creating disharmony. Without it, there is, as Melanie Phillips also noted, "no reason for minorities to compromise their sometimes mutually incompatible demands. We would end up with the politics of protest, single issue lobbies, acts of violence and tribalism. It is not in the interests of either the majority or the minorities to weaken it".

It seems to me we are heading in exactly the opposite direction. We are weakening our broad civic 'culture' through ill-considered constitutional adventures that reinforce

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9 I am indebted to JE Traue's *Ancestors of the Mind – A Pakeha Whakapapa*, Gondwanaland Press, Wellington, 1990 for this observation.

10 Phillips, M (1996), 'Unholy Pursuit of a Common Culture', *The Observer Review*, 11 February.

distinctions and focus on divisions that have, over the years, weakened and largely vanished. This is a recipe for a nervous breakdown. It is inviting strife by raising expectations that cannot be fulfilled.

What sort of society?

In terms of cultural relations the current official guiding motifs are division, difference and distinction. If we turn to the nature of New Zealand society the guiding motifs are, ironically, collaboration, collectivism and cooperation. The culprits for all that is wrong with our society tend, these days, to be seen as individualism and competition.

Recall that in her maiden speech from which I quoted earlier, Ms Wilson said that she wants to set about "creating a new society founded on the principles of equality, independence, social, economic and cultural justice". A key policy derived, presumably, from the 'equality' principle is that of closing economic and social gaps with a particular focus on Maori and Pacific Islands people who are disproportionately represented among the lowest income groups. But achieving equality involves more than bringing the bottom groups up: it also involves bringing the top groups down. Hence the increase in the top tax rate, for example. This key policy platform is, in fact, simply another exercise in redistribution. If the focus is to be on particular ethnic groups it will not be inclusive; it will ignore the poor of other ethnic groups and be divisive.

A more constructive and effective focus would, in my view, be not on 'closing gaps' but on 'lifting all boats'. This would involve alleviating poverty and promoting prosperity for all, while recognising that abilities, aspirations and levels of effort will differ and, thus, gaps will always exist. Why should we be overly concerned about gaps if all have the opportunity to get ahead? This would require us to address issues of unemployment and economic growth through effective economic and social policies, including flexible labour markets. As it is, in these and other areas, school education for example, the government is introducing policies that will make the gaps more resistant to closure.

Tied up with this programme is the government's pursuit of the 'third way', which Mr Mallard has described as:

> … an alternative between an interventionist welfare state and a 'market' rules survival of the fittest regime. The Third Way guides innovation and economic development while still looking after the basic needs of all citizens and providing opportunity, regardless of their personal background or circumstances.[11]

In this description the third way appears to act like Adam Smith's 'invisible hand' – an impersonal force guiding human affairs so that, unbeknown to individuals, socially desirable outcomes are achieved. But the third way is not impersonal – some visible hand has to control the process. Whereas in Smith's model the individual pursuit of self-interest generally serves the wider interest, Mr Mallard leaves it unclear what mechanism is to ensure that politicians serve national, rather than sectional, interests. In practice, of course, it is the government that will interpret and implement the wider

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11 Trevor Mallard (2000), speech notes for Launch of the PriceWaterhouseCooper Public Sector Leadership Best Practice Survey Report, 14 June.

interest, no doubt for political purposes and against the inclinations of individuals if necessary.

The third way is thus code for 'big government', and its agenda is deliberately so vague as to minimise the constraints on the government using its power and resources for sectional reasons. To adapt Humpty Dumpty's memorable words, the third way "will mean just what the government chooses it to mean – neither more nor less". The third way has a superficial appeal that appears to justify government involvement in all sorts of human affairs, but it leaves unaddressed the old problem of who is to control the controllers.

The present government has re-nationalised accident insurance and halted the privatisation process. However, it seems that its 'third way' ambitions are not to be achieved primarily by a return to state ownership but through the redistribution of power and resources. The constitutional changes involving the Treaty of Waitangi seem aimed at a redistribution to Maori from the rest of the population, leading to the problems I have discussed. We are also seeing an increasing emphasis on the redistribution of resources through the tax and benefit system – particularly to better-off superannuitants and tertiary students, not primarily to the poor – and a redistribution of industrial power to unions through the Employment Relations Act 2000. There are obvious problems here that are beyond my present purpose, but I would note that the pursuit of greater equality by redistribution has thus far proved to be as fruitless as its pursuit by common ownership.

One obstacle to the pursuit of equality is the assumption that poverty is invariably the result of social factors such as oppression of one sort or another. In the modern rhetoric of guilt and victimhood, old-fashioned class divisions have largely given way to new divisions based on culture. Yet some minority groups have done well educationally and economically, in spite of oppression: Indians in East Africa, Jews and Chinese in many parts of the world. All too often material poverty is the result of personal decisions and a poverty of culture. In this context I do not mean the outward symbols of culture such as language, music, festivals, dances and foods but the inner motivations and moral fibre. And here we often find that cultural relativism slides into a moral relativism in which all values have to be respected – the new school curriculum framework says so explicitly. The effects are reflected in the statistics for one-parent 'families' and crime, and in our tendency to "define deviancy down", to use senator Moynihan's catchy alliteration. Some of those who, in previous generations, would have been seen as criminals or deviants are now more likely to be considered victims of some form of oppression or trauma.

The new values undermine the incentives for the behaviour and attitudes that traditionally have enabled people to succeed. These include thrift, the deferral of gratification, perseverance, courage in adversity, hard work, acceptance of personal responsibility, and so on. As social commentator Irving Kristol puts it, "It's hard to rise above poverty if society keeps deriding the human qualities that allow you to escape from it".[12] It is also hard to encourage benevolence and generosity towards others when the state is seen as the first call for mutual assistance.

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[12] Quoted by Ken Baker (1995), 'Moral Community', a paper delivered to a conference of the Modest Members Society, Sydney, April 29–30. His paper prompted a number of the suggestions made here.

In my view, the concern of recent governments for biculturalism, multiculturalism, national identity, a new society and so on is not only creating new problems but also missing the real challenges we face. These are moral and will not be addressed by constitutional adventures or the pursuit of various 'culturalisms'.

There are limits to what governments can do to influence human behaviour. They certainly cannot legislate for morality or strong communities. But they can stop undermining both, and they can use their authority to endorse the efforts of others.

So much for criticism. What might be an alternative prescription to that currently offered by the government for the advancement of New Zealand?

First, I would give up, at least for the time being, constitutional adventures whether under the banner of strengthening national identity, enshrining the Treaty of Waitangi or removing the dreaded 'anachronisms' of our colonial heritage. Treaty of Waitangi references should be removed from legislation except to the extent they are necessary for meeting valid Treaty of Waitangi claims. They have no relevance to social policy and just perpetuate, reinforce or manufacture unhelpful differences. I would let the public have another say, by way of a referendum, on the constitutional adventure of MMP.

Having started on the Treaty of Waitangi claims process we should continue with it, but aim to end it as expeditiously as possible. We should be under no illusion about the determination required to do this. It is not in the interests of elites who benefit from the 'grievance industry' to bring about finality. That would cut short both any direct pecuniary benefits for them and also the incentives they can offer to members to stay within the tribal fold. We risk merely the illusion of finality and then all the usual arguments in any particular case for review and reopening: incomplete disclosure, fundamental mistake, newly discovered evidence, fraud, incompetence or whatever. Ironically, all these arguments are essentially Western – a fact that exposes the hypocrisy of the fashionable doctrine of cultural relativism.

Second, I would fundamentally rethink the 'closing the gaps' policy. This will almost certainly be unsuccessful because the causes have not been identified and it will end up treating symptoms. In many cases such gaps as do exist result primarily from differences in personal and family expectations and motivations. Consider the educational and employment success of the children of South East Asian refugees arriving with their worldly possessions in a plastic bag and no English. In these politically correct times the last thing a government is going to do is identify such causes because they involve judgment and moral comparisons and criticism.

The gaps will not be closed by further welfare distributions. Treaty of Waitangi settlements may simply exacerbate existing perverse incentives and, by benefiting the already well-off, widen the gaps still further. In any case, the focus should be on poverty and other indications of disadvantage, not inequality as such. The ending of the scholarship scheme enabling children of low-income families to attend private schools seems precisely the wrong thing to have done – surely it should have been greatly extended. Clearly ideological antipathy to private schools outweighed concern for the educationally disadvantaged. Similarly, tightening school zoning will just help lock disadvantaged children into poorly performing schools by reducing opportunities to move to better ones out-of-zone.

Positive discrimination seems likely only to provide excuses and support for continued failure. We would do well to learn from Californians who voted to abolish racial preferences in their schools and colleges, an initiative spearheaded by a courageous Afro-American against the opposition of the liberal elite, and banned bilingual education. Instead of increasing racial privileges as the state became more racially diverse – whites are now a minority – California re-emphasised its unitary civic culture. Minority representation dipped but then rebounded, and the test scores of minority students improved dramatically.[13]

Third, I would get serious about full employment. Unemployment encourages social and family breakdown, individual alienation and crime. There is no excuse for the unemployment of the able-bodied. It is a great evil for which successive governments are responsible. There were impressive reductions in unemployment in the early 1990s, but unfortunately further success in this area requires policies diametrically opposite to some of those being pursued, especially in the labour market.

Fourth, we must provide an environment in which the private sector can prosper and provide employment and economic growth. Without economic growth we will be back lobbying and squabbling for a larger share of the existing and possibly declining cake, not trying to enlarge its size for the benefit of all. This requires obvious policies such as low taxes, open borders, privatisation, a smaller government share of gross domestic product, a flexible labour market and respect for property rights and contracts. There is nothing at all unusual or mysterious here – the lessons of other countries and of our own recent past are there before us. The tragedy is that we are going backwards on several of these fronts and now face rising problems, including the permanent loss of too many of our brightest and most energetic young people overseas.

Fifth, I would not try to impose centralised, one-size-fits-all solutions. Individuals and organisations can decide whether and when collaboration or competition is right. Often it is not a case of one or the other. In business, cooperation is often an essential part of being competitive. The same two firms might compete in some areas and cooperate in others. Even within the same firm we can find both types of activity. Business has to be highly flexible. Any notion that in the fluid business environment, not least in our 'knowledge economy', such behaviours can be determined by the government is simply absurd. It will not work. I suspect this is also the case in other types of organisation – tertiary institutions, for example. The same considerations apply to 'individualism' and 'communitarianism'. In some parts of our lives we act as individuals and in others we act with others. It is unhelpful to prescribe the one and proscribe the other. In all spheres we need both teamwork and the brilliant individualists who can provide what the majority lack.

Sixth, in social welfare we must pay much more attention to the notion of deserts – to the difference between the deserving and the undeserving. To show how far we have come from such a notion, let me quote David Thomson's account of the attitudes of early colonial governments in New Zealand:

> … they insisted that a legal right to assistance from one's fellow citizens would not be established, and that the values of charity would guide all welfare activity beyond the family. The abiding principles would be voluntary assistance rather than compulsory support, minimal formality

13 Andrew Sullivan (2000), 'United Colours of America', *Sunday Time*s, London, October; Rowan Taylor (2000), 'Getting Closer', *The Listener*, 25 November; David McLoughlin (2000), 'Lessons we could all learn', *The Dominion*, 22 November.

> rather than statutory structures, charitable donation rather than tax funding, individualised assistance rather than relief to whole groups or classes, and rigid discrimination between the worthy and deserving, and the unworthy and undeserving.[14]

Thomson goes on to tell us that in the 1870s there were "impressive debates on charitable aid" during which "[p]rinciples were explored with some sophistication, elegance and tolerance of alternative views". We need to engage in a similar debate and with the same sophistication and openness. This would be much harder today when the language of 'charity' and 'undeserving' is unacceptable to many and the notion of 'rights without obligation' so firmly entrenched. But such a debate would, in my view, be far more profitable, if conducted with courage, sensitivity and real leadership, than high-sounding fulminations about national identity and a new society that lack reference to individual morality and to the duties and obligations connected with rights.

Seventh, family policy should put the welfare of children first. This, I think, would be widely accepted, but quite how to give effect to it is not nearly so clear. The relevant statistics tell us that, in general, children do better, in all sorts of ways, if brought up by two parents in a stable relationship. There are no easy answers to the problem of family breakdown, but we cannot shy away from open debate on it if we are to address some of the serious social pathologies.

The last element in my alternative prescription is that we should remember the things about which New Zealand can be proud, including our social cohesiveness. Of course, our history includes times of conflict and injustice, but there is far more that keeps us together than divides us – our democratic and legal institutions, our common language, and our common citizenship under one law – notwithstanding our many ethnic origins. Our easy tolerance of cultural and religious diversity is in fact an enormous strength. My concern with so much talk today about national identity, biculturalism, the Treaty of Waitangi, and a 'new society' is that it can undermine those impressive strengths by creating or accentuating differences – in giving distinctions a significance that most people just do not acknowledge. At the same time it diverts attention from some deeper and far more difficult 'cultural' issues crying out for serious attention.

Conclusion

Malcolm Muggeridge wrote some 20 years after the end of the Second World War about the relative shortness of the impact of Mussolini, Stalin and Hitler.[15] What had carried the day, according to Muggeridge, was not the legacy of these murderous tyrants but liberalism as the dominant ideology of our time. By 'liberalism' he had in mind a woolly moral permissiveness that looked benignly on evil and was prepared to countenance the destruction of the moral edifice on which civilisation had hitherto been based. Muggeridge went on to ask:

> Why ... should this alluring and amiable view of life seem to have led to its own negation – instead of brotherhood to a collectivity; [and] instead of freedom, brain-washed conformism … How did it come about that the

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14 David Thomson (1998), *A World Without Welfare: New Zealand's Colonial Experiment*, Auckland University Press with Bridget Williams Books, Auckland, p 28–29.

15 Malcolm Muggeridge (1966), 'The Great Liberal Death-Wish', *New Statesman*, 11 March.

> pursuit of peace led to ever more ferocious wars, of happiness to ever larger and more crowded psychiatric wards, of knowledge to ever greater credulity and vacuity, of security to an ever intensifying sense of helplessness and loss of identity …

He ended his article by pointing out that this nightmare was not being imposed by ruthlessly efficient power-maniacs on the Fascist or Soviet model but was being born and nourished in some of the finest, most civilised and most humane minds of the time. Muggeridge concluded, "For our Dark Ages it is we ourselves who are turning out the lights, fondly supposing that we are turning them on". I suggest we could usefully reflect on Muggeridge's musings when faced with calls for a 'new society'.

NEW ZEALAND BUSINESS ROUNDTABLE SEMINAR
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THE FUTURE AND ITS ENEMIES

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***REASON* MAGAZINE**

WELLINGTON
30 MARCH 2001

THE FUTURE AND ITS ENEMIES

The twenty-first century does not look much like they told us it would be when I was a little girl in the 1960s. We used to think the twenty-first century would look pretty much like *The Jetsons*. There would be flying cars, of course. Everyone would live in a high-rise apartment building with a robot maid and a stay-at-home mom. Fathers would work in big corporations making industrial products like Spacely Sprockets. There would be no dirt, grass, trees, or backyards. The future would have no old-fashioned houses, no suburbs, no shopping malls. It would have no blue jeans, sneakers, skateboards, or scooters. It certainly would have no goth teenagers, evangelical Christians, Internet billionaires, *feng shui* consultants, or Harry Potter books.

The twenty-first century that we imagined back then was clean, neat, and orderly, and so were its inhabitants. It would be a future in which neither the clothes nor the society had any wrinkles. Even dystopias such as *1984* , *Brave New World*, and *Fahrenheit 451* imagined a controlled, conformist, predictable world. That is not the world we got.

But the future also does not look like they told us it would when I was a teenager in the 1970s. We have not run out of oil. The currency has not collapsed. Famine has not swept the world. We did not have a nuclear war, and the Soviets did not conquer Europe. We have not destroyed ourselves with credit cards. We are not living on self-sufficient communal farms. People still get married. Unemployment is low. Men do not wear leisure suits, and women still wear bras. In fact, bra design is a pretty high-tech, high-fashion business these days.

The future, it turns out, is messy and unpredictable. It does not develop according to plan. Indeed, there is no such thing as 'the' future – or, for that matter, 'the' present or 'the' past. Human life is filled with more variety than we can get our minds around, and that variety appears to be increasing. We live in an era of fantastic cultural and economic plenitude. It is a magnificently creative era. But that creativity produces change and uncertainty – and a lot of people do not approve. Sometimes these opponents are merely protecting their interests – trying to stamp out the competition, for instance. But interests are not the whole story.

A new political, cultural, and intellectual landscape is emerging, one that is different from the comfortable old left-right dichotomy.

On issue after issue, we are seeing similar debates: is the Internet dangerously out of control, or is it a model of how order can evolve without design? Is international trade the great hope for peace and prosperity, or should traditional ways be sheltered from foreign influences? Would choice and competition improve education, or would they destroy standards and fragment society? Should medical progress be driven by the creativity of researchers and the desires of patients, or should central authorities create what the bioethicist Daniel Callahan calls 'sustainable medicine' that has "embraced finite and steady-state health goals and has limited aspirations for progress and technological innovation"? From professional licensing to popular culture, from transportation to global financial markets, from immigration to suburban 'sprawl', we see similar debates and unfamiliar divisions. The open-ended future has become the central issue of our time, as important as the Cold War once was in determining our political categories.

On one side of the new divide are those who crave *stasis*. Their central values are stability and control. They want to curb, direct, or end the unpredictable, trial-and-error experimentation through which the open-ended future evolves. They want a 'steady state'.

They seek 'one best way'. They are at war with creativity, enterprise, and progress. Now, generally speaking, you will not get far in politics by calling for a war on creativity, asking the president to appoint an 'anti-creativity czar'. So stasists aim their attacks at the *processes* that carry those values: at markets, technological innovation, cultural exchange, scientific discovery, artistic expression, the reinvention of the self.

Stasists can take several forms. Some are traditionalists, 'reactionaries', who idealise an unchanging society, usually a version of something in the past. Depending on who is talking, that ideal past may be just a few decades ago – an idealised version of the 1950s or even the 1930s (minus that nasty Depression). Or, as in the most extreme green writings, it is before we screwed things up with the invention of agriculture. What these reactionary visions have in common is the belief that life would be better if everyone knew their place from birth, and life was stable and predetermined.

The more common stasists are 'technocrats', who say they are for the future, for change, but only if it is planned and controlled – a future that follows their 17-point plan. The technocratic version of stasis is expressed in Bill Clinton's 1996 slogan, 'Building a Bridge to the 21st Century'. As an upbeat slogan, it certainly beat Bob Dole's promise to build a bridge to the past. As a vision of society, however, it promised stasis. A bridge is a uniform, rigid, static structure that goes from point A to point B over a scary abyss. A bridge to the future suggests that we will all start and end at identical places, and that our lives will be determined by someone else's blueprint.

On the other side of this great divide are those who support *dynamism*. Their central value is learning – an open-ended process of discovery and improvement. Dynamists therefore seek not to impose a particular vision of the future but only to protect simple, underlying rules that allow many different visions to compete and to coexist.

Dynamic, open systems – cultural, economic, scholarly, scientific, and artistic – defy and erode central control. They rely instead on decentralised innovation, competition, choice, and criticism. They make it possible to have progress without a plan – an open, unpredictable future that meets human needs and wants better than the past. Instead of figuring out in advance what the future should look like, we learn gradually, by trial and error. We make plans not for everyone's future but for specific, decentralised goals, and we test whether our plans are correct. We do not put all our eggs in one basket, and we allow people to use their particular, local knowledge of their own circumstances to make their own plans.

What I want to do in the rest of my time is talk a little bit about where that sort of open-ended progress comes from. If progress does not mean marching toward utopia – following a known plan or crossing someone's well-designed bridge – how does it happen?

First, I will talk about the 'demand side' of progress – how we figure out what we want, through a process that has been called 'form follows failure'. Then, I will talk about the 'supply' side of progress – the way near-infinite combinations make open-ended creativity possible. Finally, I will look at why we need open systems in order to sort the good ideas from the bad ones, and to make progress over time.

The demand side of progress: 'form follows failure'

Stasists tell people to be content, and they assume that most of us would be happier if the world did not change much, especially in unpredictable ways. But it turns out that people are not nearly as complacent as stasists suggest. To the contrary, there is always somebody out there with a gripe and – if we are lucky – someone with an idea of how to make things better.

The civil engineering professor Henry Petroski calls this process 'form follows failure'. By that, he does not mean that a product fails to do what it is designed to do. He means that as soon as something is invented, people start to see ways it could be better.

Take contact lenses, one of my favourite inventions. Once you have lenses that can be worn all day, you want ones that can be worn all night. Or, if you get them cheap enough to throw away every week or two, you want them cheap enough to replace every day. And you start imagining new kinds of lenses you might invent. What about contact lenses to change eye colour, protect from ultraviolet rays, or correct astigmatism? Down the street from where I live, there is an optometrist advertising funky lenses that give you red vampire eyes, make your pupils look like 8-balls, or turn them into starbursts. Maybe we would like lenses that function as computer screens or navigational guides. Each new improvement suggests others, and the perfect contact lens is always out of reach. Indeed, given different needs and different tastes, it is highly unlikely that a single best lens would suit everyone.

The very nature of progress dictates an inherently open, and imperfect, future. And That is what stasists do not like.

The supply side of progress: the power of combinations

If our quest for improvements explains the demand for progress, there is still the question of the supply: How is open-ended progress possible? Aren't we 'running out of resources'? Isn't the world finite?

It turns out, however, that the real limit on progress is not the amount of stuff we have, or even the number of ideas, it is all the ways that stuff or those ideas can be recombined. And once you start combining things, the numbers get very big, very fast.

Here I have six standard Duplo blocks, the larger size version of Legos. According to the Lego company, these six blocks can be combined 109 million different ways. And that is just six blocks. An ordinary deck of 52 cards can be recombined 10 to the power 68 different ways – one followed by 68 zeroes – which means that any time you shuffle a deck of cards that particular order has probably never come up in the history of cards.

And, again, 52 is a relatively small number. The ones and zeroes on an ordinary 1.4 megabyte floppy disk can be recombined 10 to the power 3.5 million different ways – one followed by three and a half million zeroes. Those combinations could be words, they could be music, they could be graphics, or computer programmes, or equations, or any combination of the above. You start to see why people who work with computers can imagine nearly infinite progress – and why musicians or writers rarely fear that their profession will 'run out of resources'.

New combinations can supply the demand for progress in several different ways. They can create new sources of happiness, solve old problems in new ways, or simply increase the abundance from which individuals can choose.

Take the Sony Walkman. It began as a mock-up of a full-size cassette player with big clunky earphones. The charge to Sony engineers was essentially, 'Make something that does this, but is small enough to be carried on your belt'. The idea for the product began as a combination of existing ideas – the form of Sony's successful transistor radios with the newer cassette technology and high-quality earphones. The challenge lay in solving the size, weight, and price problems.

You can also attack old problems with new combinations. How many of you know what a McFlurry is? It is a new McDonald's product – a combination of their soft ice cream with various candies. You select, say, M&Ms, and they put it in the ice cream and swirl it around with a machine so that it creates a new flavour. That is a yummy combination but not the really interesting one.

The interesting combination is the tool they use to do it: this spoon. These sorts of blend-ins have existed for a long time in other shops, but they always have a problem. It is hard to keep the big corkscrew that creates the mixture clean. Either the flavours get mixed up with each other or the workers have to spend a lot of time cleaning.

The McFlurry solves this problem with this spoon. It combines the spoon you need to eat the dessert with the tool McDonald's needs to create it. The handle is hollow and fits on to the machine. The spoon itself is what turns to create the blend of candy and ice cream. And the customer walks away with the mess – no cleaning necessary.

Finally, there is the progress of pure abundance. My local discount store stocks around 30,000 different music titles – on Internet sites you can buy 10 times that many, and That is without considering the sites that allow downloads – so that there is something for every taste and every mood, including the desire for novelty itself. In some cases, as with the McFlurry spoon, new inventions improve on and replace what has gone before. In others, however, as with music, new combinations simply add to the richness of the world. That idea is something stasists often miss. Their own tendency to seek 'one best way', a single static norm for any society, blinds them to the fact that progress does not necessarily mean replacing the old with the new. New and old may coexist, and they may recombine in creative ways.

Testing our creativity

In a dynamic, learning system, the process of innovation generates feedback – 'criticism by example', better known as competition, and 'criticism by expression', better known as, well, complaining. In an open system, these two forms of criticism encourage improvements. They allow us to sort the good ideas from the bad ones, and to encourage incremental improvements.

But when criticism, competition and choice are cut off, the demand for improvements goes unmet. In a closed system, where progress means meeting a known goal, you have to stick with what you have got.

Consider the boots worn by US Marines. The Marine Corps certainly wants good boots for its troops. Footwear has been a military concern at least as far back as the Roman legions: troops with sore feet are at a strategic disadvantage, and soldiers do a lot of walking.

So the good planners in the Marine Corps have, for decades, told shoe manufacturers exactly how to make its boots. They have laid out the requirements in fat tomes. The result: Marine boots were essentially the same in 1999 as they were in World War II –

cold in winter, hot in summer, hard to break in, and hard to get dry. Individual marines applied a host of 'form follows failure' strategies to deal with the problem: vaseline, powder, wrapping their feet like a boxer's hands, wearing various combinations of socks. But the boots themselves did not change, because improvements were not in the plan.

Commercial footwear, meanwhile, experienced enormous improvements in materials and designs. Gadget-loving techies have nothing on the people who buy outdoor equipment when it comes to lusting for new and improved technologies. A competitive market serving outdoor enthusiasts rewarded fruitful innovations and pushed for even more. Boots became ever more weather-resistant, shock-absorbing, fungus-proof, and adapted to difficult terrain. They did not stick to old materials, like leather, or old designs. Finally, then-Marine Corps Commandant Charles Krulak decided that the corps should take advantage of what commercial boot makers had learned. As of a few months ago, Marines are wearing boots originally designed for civilians. And, as a sergeant told the *Los Angeles Times*, "the new boots are like something from heaven".

True to the demand side of progress, however, even the heavenly new boots are not perfect. For instance, the heels tend to wear down quickly under the pressures of Marine marching. So the boot makers are working on a new heel. Form follows failure: you can always do better. As Henry Petroski also observes, "The future perfect can only be a tense, not a thing".

Marine boots are not an isolated example. They represent what happens whenever well-intentioned people operate in a protected environment, without competition and criticism to expose them to new ideas and push them to improve. We have learned in the past week that ballot design and voting technology in the United States have similar problems. The great value of free trade is not just the economists' story of comparative advantage, as true as that is. It is the learning that occurs when businesses face competition and when knowledge of new techniques flows across borders.

How civilisations learn

In the end, the battle between stasis and dynamism is a battle over how civilisations learn and whether they should. Dynamists have great hopes but they make modest claims. They acknowledge that we are largely ignorant and that there is always room for improvement. The knowledge of what people really want, of what improvements are possible, of what complimentary ideas might enrich them further or what competitors might supersede them – all this knowledge is scattered. We do not know in advance what will constitute 'progress', or what the next stage in its incremental evolution might be. All we can do is start from where we are, try to do better, and correct errors as we go.

This infinite series of experiments and feedback can be unsettling, even scary. But only through such efforts can we better ourselves and our posterity. And only through them can we realise our full humanity. As Friedrich Hayek so aptly wrote, "it is in the process of learning, in the effects of having learned something new, that man enjoys the gift of his intelligence". It is in curiosity, problem-solving, and creativity that we discover who we are. These are the very qualities and activities that make the future unknown, unknowable, and filled with promise.

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