Getting Serious about Economic Growth

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

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FOREWORD

This collection of speeches, submissions and articles is the eighteenth 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), *Can New Zealand Afford to Replay the Economic Past*?(2000) and *Choosing a First World or a Third World Future* (2001).

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 a paper by Bryce Wilkinson, consultant to the NZBR, and an article by Phil Barry, author of a NZBR report published in 2002, *The Changing Balance Between the Public and Private Sectors*.

A full list of NZBR publications is also included.

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ECONOMIC DIRECTIONS

ELECTRA BUSINESS FORUM

GETTING SERIOUS ABOUT ECONOMIC GROWTH

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PARAPARAUMU
2 OCTOBER 2002

GETTING SERIOUS ABOUT ECONOMIC GROWTH

I want to talk here about economic growth.

Our politicians also like to talk about growth. They especially seem to like talking about growth targets.

When politicians stand up to talk about lifting New Zealand's growth rate, or getting New Zealand back up the Organisation for Economic Cooperation and Development (OECD) league tables, we typically get a speech that is long on generalities, objectives, targets and – let's face it – wishful thinking. We have set plenty of growth targets in New Zealand, and have achieved a fair measure of consistency in missing them.

In the political domain, setting targets is a bit like a bidding round in a hand of poker – but one where everybody is bluffing.

Our experience of playing this game of poker goes back a long way. In the early 1970s I was involved with the National Development Conference, which opened the bidding with a 4 percent growth target. Later in the 1970s, after the first oil crisis, the Planning Council, no doubt sensing New Zealand held a weaker hand, lowered its bid to 3 percent.

Following the hard work done by the Labour government between 1984 and 1988, the Bolger–Birch government raised the target to a 3.5–5.0 percent range. In his time as treasurer, Winston Peters raised it again to 6 percent. He was clearly bluffing, and in fact dropped most of his cards along the way. He was eventually asked to leave the table.

Not to be outbid, Jenny Shipley matched Winston at 6 percent – another outrageous bluff on a weak hand. Bill English more or less folded by dropping National's target back to 4 percent. We should give him credit for being realistic, given that National's recent approach to policy has been singularly unadventurous and, like Labour's, has no show of really lifting the trend growth rate.

Political talk of growth targets is pretty much a code word for avoiding the issue. Talk is, we might say, inexpensive.

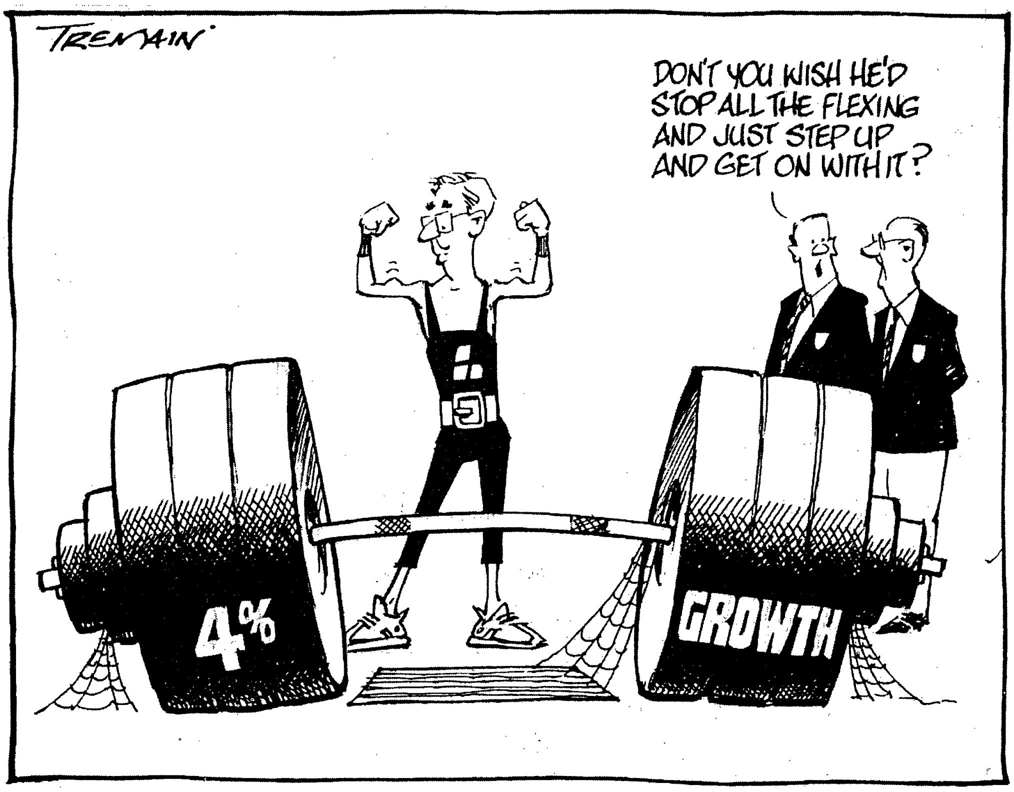
And so we find the current government indicating that its top priority for this parliamentary term is to raise New Zealand's economic growth rate, a commitment that was highlighted in the Speech from the Throne at the opening of parliament recently.

But targets and intentions are of no value without policies to achieve them. The following Tremain cartoon makes the point rather well.

In spite of our justifiable scepticism, we should hold our politicians to account. We must push and prod them to demonstrate that beneath the packaging there are policies of substance. Because the stakes are high. If we revert to another decade of second-rate performance, the outflow of talent we have seen will turn into a torrent.

Let's define a few terms. Growth is all about expanding output, the production of goods and services that people value and are prepared to pay for.

SUNDAY STAR★TIMES SEPTEMBER 1, 2002



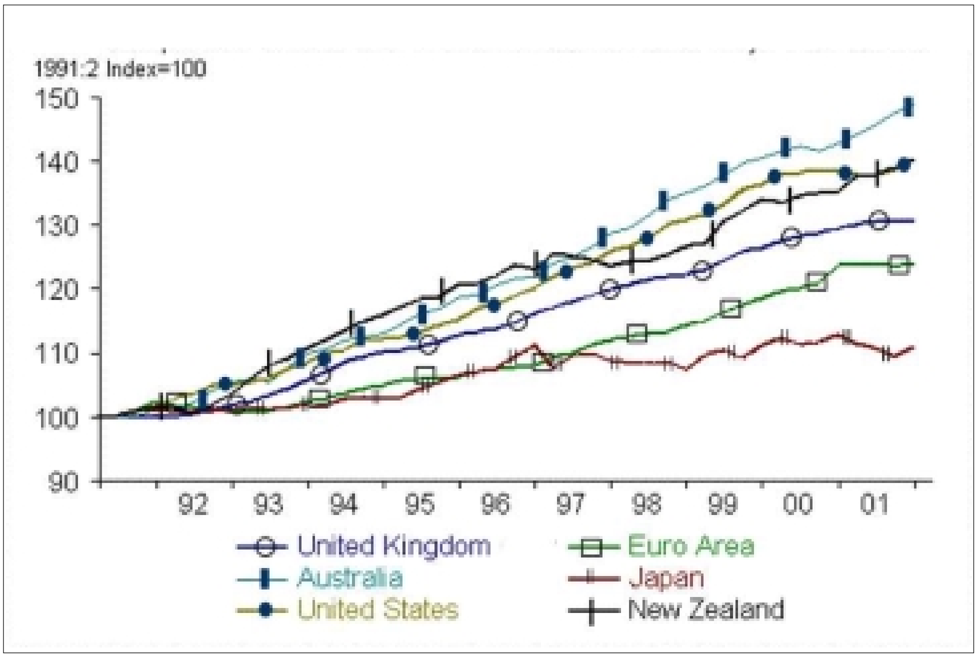
If output expands, so too, generally speaking, does national income. In fact output and income are opposite sides of the same coin. In national accounting terms, they are an identity: output equals income. So we can talk of New Zealand's growth performance in terms of output growth rates, or in terms of growth of national income.

Back in the 1950s we were not too far from the top of the international league tables for average income per person. But, in the three decades to the end of the 1980s, real gross domestic product (GDP) per head rose by only 0.8 percent per annum, well below average OECD rates. This meant our relative incomes fell up until the beginning of the 1990s. Moving permanently overseas began to look increasingly attractive to many New Zealanders.

This relative decline in growth was halted in the 1990s, a decade in which our average per capita income grew at nearly the OECD average. Contrary to all the nonsense spouted about 'the failed policies of the 1990s', the following chart shows we were well up with the pack. In other words, the painful policy changes from the mid-1980s halted the decline, and we are now at least managing to hold on to our new, albeit more lowly, ranking.

How low is it? Well, in 2000 New Zealand's average per capita income on a purchasing power parity basis was about US$20,000. Australia was about 30 percent ahead of us, at US$26,300. And about 40 percent ahead of Australia was the United States. Despite all the anti-Americanism you hear from the world's cultural elites, it is no wonder that the United States is the number one country of choice for most of the world's migrants.

Figure 1: Comparison of New Zealand's GDP performance with other major economies



But why is it that most developed countries have a per capita income that is higher than ours? The answer comes down essentially to *productivity* – higher output per worker. Ultimately, the trend decline in our relative income reflects slower productivity growth than other countries have achieved.

So why is this? The answer is that, compared with New Zealand, the average worker in the United States and many other industrial countries:

- works with more and better capital;
- is better educated, and thus is better able to utilise that capital;
- is surrounded by good physical infrastructure (for example, efficient ports, airports, telecommunications, road and rail transport, and health systems);
- works in a relatively low-cost regulatory environment;
- in part of a labour market where businesses are able to hire and fire quickly, and thus can organise their operations at lower cost; and
- has a strong incentive to work because the welfare system is a low-slung safety net and the tax system does not massively erode the take-home pay of the average worker.

These are some of the key factors underlying productivity growth. Using these, let me briefly try to interpret for you New Zealand's slide down the income rankings until the 1990s. Later, I will use this framework to look at what needs to be done now.

The decline in our real incomes relative to the rest of the world didn't just happen. It had reasonably obvious causes.

First, New Zealand industries were sheltered behind high import licensing and tariff barriers for much of that time. Businesses had the incentive to invest in activities that were never likely to be internationally competitive. Thus, much of our business capital spending was misdirected – into, for example, car and television assembly industries that were ultimately doomed. Fortress New Zealand resulted in the average worker working with second-rate technology and capital equipment. Protected markets have an immediate cost to consumers, but they have an even higher and longer lasting cost by channelling business investment into socially wasteful activities.

The lack of international competition allowed obsolete organisational practices to linger on. The worst was the labour relations system we inherited from Britain – a huge drag on productivity. Recall the decade-long construction saga associated with the Bank of New Zealand head office building in Wellington and the endless industrial disputes in our forestry, meat, ports and shipping industries.

Over this 30–40 year period, the New Zealand worker faced an ever-larger tax grab from the government, while welfare policies got more and more expansive, making not working and not saving easier options. So dramatic has been this expansion of the welfare state that the Savage and Nash governments of the 1930s and 1940s would have more in common with the ACT Party today when it comes to welfare policy. Savage was concerned that welfare be a hand-up, not an open-ended handout. He insisted that pensions should be means-tested. Total government spending was under 20 percent of GDP in 1938, compared with around 40 percent today.

Singapore, by contrast, chose a better path. Lee Kuan Yew writes of watching the ever-increasing costs of welfare in Britain and Sweden and deciding that Singapore must avoid such a "debilitating system". In his words:

> People did not have to work for their families' well-being. The handout became a way of life. The downward spiral was relentless as motivation and productivity went down. People lost the drive to achieve because they paid too much in taxes. They became dependent on the state for their basic needs.[1]

We used to give foreign aid to Singapore. Now there are plenty of Kiwis working in Singapore enjoying much higher incomes than they could achieve in New Zealand.

Looking back at our experience, it is perhaps a wonder that New Zealand was not even poorer by the 1980s. Part of the reason is that such decline happens at the margin, as capital depreciates and old attitudes of self-reliance gradually decay. Unfortunately, the same is true when you are trying to catch up – you start with your existing capital stock and your new soft-minded attitudes and habits.

Merely stopping the relative decline is not good enough. New Zealand has to find policies that will allow us to catch up, and to recover the losses of the past half-century. And we need to do this in a world where other countries are energetically trying to do the same – more energetically than we are in most cases.

In spite of this, catching up is not a forlorn hope. There is not the slightest need to be defeatist about it. There is so much, so easily identifiable, to be done. We just have to get serious again – as governments were for brief periods in the 1980s and 1990s.

An obvious starting point is to focus on the things that lift productivity growth.

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1 Lee Kuan Yew (2000), *From Third World to First: The Singapore Story 1965–2000*, Singapore Press Holdings, Singapore, p 126.

Allocation of capital

Consider the capital that workers use. This is all about the scale of business investment, and the allocation of it. Capital is scarce and thus costly – which is why the government must stop wasting it. To allocate capital well, we need to continue to open the economy up to the world. We must work to reduce the burden of compliance costs that businesses bear. The more labour-intensive service sector is particularly sensitive to the regulatory environment and to labour market laws.

Where are we headed at the moment? Absolutely in the wrong direction. Tariff reductions are stalled and central and local government are wasting scarce capital by engaging in futile gestures with industry subsidies and uneconomic investments such as Kiwibank and rail schemes in Auckland. The regulatory burden is getting more oppressive, taxes have risen and become more complex, and employment is becoming more and more a hazard for employers who are not high court judges. All these trends unambiguously slow productivity growth and need to be reversed.

Infrastructure

Two words exemplify the nature of the problem: Auckland roading. Australia is well ahead of New Zealand in operating infrastructure industries like roading and water on a commercial basis. Anyone who has travelled widely overseas is well aware of the scope for toll roads, public–private partnerships and user charges. These are areas where central and local governments are the problem, and they need to step out of the way. We need a major kick-start to privatisation, which has stopped and even reversed. Electricity is predominantly a private sector industry overseas, but in New Zealand is still state-dominated. Other countries have shown we need to move further – even countries like Germany and Sweden have privatised postal services, hospitals and universities.

Education and health

Education and health are also part of the infrastructure of the country.

A progressive lowering of educational standards is affecting literacy and numeracy, arguably with a big impact on families in lower socio-economic groups who can't escape under-performing local schools. Much of this reflects the typical problems of a public monopoly. Labour relations in these state monopolies have a time-warp feel to them, an unpleasant reminder of what things were like back in the 1970s and 1980s.

Why do we have this absurd fetish about governments running our schools? Plenty of countries don't have the old public sector model. In Ireland, most schools are private but publicly funded, and the Netherlands, Denmark and Sweden have all moved away from a state monopoly education system. In the United States, the school choice movement is rapidly gaining ground. Even in Australia, 30 percent of children attend non-government schools. The story is much the same in tertiary education.

Our monopolised health industry is a shambles and a disgrace. Better models for New Zealand are those of some European countries where private insurance plays a significant role, and where there are many private providers. In France, one-third of hospitals are private, in Germany half, in the Netherlands 85 percent.

The government seems pathologically hostile to the very idea of private schools and hospitals. The convictions of most of its members seem to date from the liberal-left politics of the 1960s and 1970s. They are the survivors of an ideological shipwreck, leaving generations of students floating on the wreckage of their devotion to the concept of a monopolised state education system. In the health sector, patients are still waiting in queues for the lifeboats, with the ships listing badly.

The problem is well analysed; there are plenty of successful international precedents for a private sector role. Why the government refuses to consider experimentation must be more a psychological question than an empirical one.

Regulatory environment

New Zealand businesses face a bewildering thicket of intrusive regulation. The statute book contains around 2,000 public, local and private Acts, comprises 89 volumes and about 65,000 pages. We must now be approaching ten thousand commandments. Most of them reflect the political success of special interest groups rather than the overall public interest. The resulting environment is a spectacular productivity killer, greatly increasing business costs and uncertainty, and wasting vast amounts of time, energy and capital. The Resource Management Act 1991 stands out as a massive roadblock to development. All New Zealanders lose from excessive regulation. One wonders how many times we have to shoot ourselves in the foot before the painful message finds its way back to the brain.

Labour market

Labour relations are crucial to the productivity story. When the 1991 Employment Contracts Act came in we saw spectacular gains in productivity – in spite of the efforts of the Employment Court. Unemployment fell and real incomes rose strongly in the latter half of the 1990s. The Employment Relations Act 2000 was a backward step, and some of those gains will inevitably be lost.

Opponents of a freer labour market do not seem to understand that if it is easy to fire people, businesses will enthusiastically hire them. In a growing economy there is a lot more hiring than firing. But, if policy makes it costly for a business to downsize when necessary, employers will be reluctant to hire. The survival instinct is strong, so firms will put people on short-term or part-time contracts, and will substitute capital for labour where possible. This is fine for those still employed, but not so good for those wanting a job.

Labour market regulation is one of many areas where good intentions – the desire to protect particular workers – lead typically to disastrous results for the community at large. Even Australia's labour laws are now better than ours in many respects, and that is a serious issue for trans-Tasman competitiveness.

Welfare and tax policies

We are also going backwards with tax policies and welfare. Taxes have risen already, and with the government's enthusiasm for spending, assisted by the need under the Mixed Member Proportional (MMP) electoral system to placate coalition partners with their pet programmes, the drift of the overall tax burden can only be upwards.

Our welfare policies are going in the opposite direction to those of the United States, Australia and other countries. The core feature of the US welfare reforms has been the conviction that work, not welfare, should be the norm. Intensive efforts in the United States to get beneficiaries back to work, coupled with time limits on assistance, have halved welfare rolls and improved social indicators across the board.

In respect of pensions we should, like Australia, ensure that they are a safety net that is targeted, not universal, with both income and asset tests.

Where to now?

The government has a reputation – and a deserved one – for moving in a measured, predictable and single-minded manner. There is a steady hand on the wheel. It is just a pity we are headed in the wrong direction. My real worry is that the government doesn't seem to realise it yet.

The economy is still benefiting from the reforms of the past 15 years or so, and we have had a boost from a relatively strong world economy and high export prices over the past few years. The golden weather, however, looks to be ending. And in economic management, the costs of bad decisions, like the benefits of good ones, take time to show up.

We know that most of the countries whose income levels we aspire to, and to which our citizens are migrating, are moving ahead with much of the reform agenda I have outlined. On current policies, our income levels, after holding their own for the past decade, will resume their decline relative to countries like Australia and the United States.

If we continue on this path for another decade, we may find our living standards not 30 percent behind Australia's, but 50 percent. And if that happens not many energetic people will want to stay.

Ironically, it was a Labour government in the mid-1980s that started the reforms that helped arrest New Zealand's relative decline. It looks like being the singular achievement of its successor to put New Zealand back on a declining path.

My vision of the future for New Zealand is not as a rest home for the retired and a trap for the unsuccessful, with a sideline business as a picturesque, low-cost theme park for the wealthy from overseas.

We can do much better than that.

SALES AND MARKETING EXECUTIVE
INTERNATIONAL ASSOCIATION

WHY GROWTH MATTERS

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

WELLINGTON
20 AUGUST 2002

WHY GROWTH MATTERS

In the recent election campaign, nearly all of our political parties – the main exception being the Greens – were talking about the need for higher economic growth.

Growing the economy – wealth creation – rather than income redistribution ('closing the gaps') is now the government's declared goal. The prime minister, Helen Clark, has nailed her colours to the mast of returning New Zealand to the top half of the Organisation for Economic Cooperation and Development (OECD) per capita income rankings. This is bound to be the issue on which her government's record is judged.

Achieving this goal is a huge task. It means that real gross domestic product (GDP) per person has to grow by at least 4 percent a year on a sustained basis. Even at that rate it would take nearly 20 years to reach the prime minister's goal.

Given that most parties have similar ambitions, you would have thought competing views on the means of achieving them would have figured large in the election campaign. Curiously, they didn't. As many commentators pointed out, there wasn't an economic debate. I believe most economists would say that to date, policy changes made by the government have been more anti-growth than pro-growth. Yet the government's claim that it has managed the economy in line with its stated goals wasn't seriously contested in the campaign.

What explains this curious state of affairs? Did the opposition parties do a poor job? Did the business community fail to spell out the policies it saw as necessary for growth? Did the media fail to elicit sound, independent economic commentary? Was the country lulled into a false sense of security by the relatively benign economic climate of the last couple of years? Have New Zealanders become cynical about all parties' aspirations for growth? Is it that they don't understand what New Zealand needs to do to be more successful? Maybe people don't really want to accept the changes needed for greater prosperity – are they content with the status quo? Are we just resigned to being losers?

One could answer 'yes' or 'perhaps' to all these questions. Certainly, there has been a longstanding record of setting growth targets and failing to achieve them. The National Development Conference in the early 1970s targeted a 4 percent growth rate. The Planning Council in the late 1970s opted for 3 percent. The Bolger–Birch government talked of 3.5–5 percent growth, and in his time as treasurer, Winston Peters talked of 6 percent. None of these targets was met. As finance ministers Roger Douglas and Ruth Richardson didn't set specific goals but instead put in some of the hard work needed to get faster growth – and the economy did grow by almost 4 percent a year in the five years to 1996. Mostly, however, it has been a matter of backing off the challenge – Jenny Shipley committed National to a target of 6 percent growth and Bill English promptly lowered it to 4 percent.

I would be the last to argue that we should be fixated about growth – that increased GDP per person is the only thing that matters. We could probably get higher growth by passing laws that required people to work 60 hours a week, but who would want that? Leisure is part of the general quality of life. So too is a good environment, and there can be trade-offs between growth and the environment. There are many other things in life that people value. Economists prefer to capture all of them by talking about maximising welfare, not growth.

So I have no problem with those who just want to chill out rather than earn more, provided they don't expect to live at the expense of other taxpayers – and don't stop those who want to improve their lot from doing so. But I don't believe most people are indifferent about getting ahead. I have yet to hear of a union that doesn't want higher wages (or other benefits) for its members. Grey Power is not known for arguing that superannuation could be cut. Most people prefer higher material living standards to lower ones, other things being equal. It's a basic human instinct to want to do better for oneself and one's family. Political parties that set more ambitious goals for the economy are surely reflecting widespread desires in the community.

Does it then come down to insufficient understanding of why growth matters, and how we could get more if it? Perhaps we are now getting to the heart of the problem.

I think the case for growth is often poorly articulated. Most people don't have a clue about what "getting up the OECD rankings" really means. The concept is far too abstract. Nor is the politician's typical argument that growth would allow more government spending – on health, education or anything else – the right starting point. Growth in the first instance is about producing more goods and services that people value. More output means higher incomes. Most gains in income would go on private spending. For people who are struggling, that would mean more food on the table, new shoes for their kids and maybe the chance of a holiday. For others, a growing economy would mean a better car, a chance to own their own home, more money of their own to spend on education or health services, or an earlier retirement.

With a growing economy it is easier to create jobs. People on welfare can get work more readily. Richer countries are cleaner – contrary to the views of the Greens and, it seems, the Parliamentary Commissioner for the Environment, by and large growth is good for the environment. Richer countries are also healthier and safer. And, yes, tax revenues grow as well, so governments have more money to do the things we need governments to do.

In short, growth expands choice and opportunity. It allows people the chance to fulfil more of their dreams. It means that more of our talented young people would live and work here, and that parents won't have to go to the other side of the world to see their kids. A wealthier country means that older people don't have to travel to Sydney for a hip operation.

People say that we don't pay teachers enough. But teacher pay in New Zealand is not low compared with average earnings – indeed the average teacher is in the top 15 percent of taxpayers. New Zealand spends more on education relative to GDP than all but two OECD countries. Most of it goes on teacher salaries. It's true that teachers are better off in the high-income countries, but the real problem is that incomes in general in New Zealand are too low.

Consider Australia. Partly as a result of its good economic performance in recent years, Australia is in the top half of the OECD income rankings. On a purchasing power parity basis its average per capita income, at NZ$57,000, is $13,000 or about 30 percent higher than New Zealand's average of NZ$44,000. Think what a difference $13,000 a year would make to many New Zealand households.

Why are incomes in some countries higher than others? The answer is simply that their people are more productive. A higher income and standard of living are dependent upon higher productivity and output. In essence, output and income are the opposite sides of the same coin. Output is the value of the goods and services produced in an economy and income is what is paid to those who produce them.

Without higher productivity per worker there can be no increase in wages per worker. For example, the average worker in the United States is better educated, works with better technology and benefits from more efficient organisation than the average worker in China or India. Thus, the average US worker produces approximately 20 times as much value of output as an average worker in China or India. American workers earn more because they produce more – and the average per capita income in the United States is about 40 percent higher than it is in Australia.

Productivity gains are the only long-run source of higher incomes. In particular, government income redistribution is no substitute. Not enough is earned by people in high-income brackets for any form of redistribution to make much difference to those at the bottom end, and policies for redistribution blunt incentives and make the total cake smaller. Governments should provide a social safety net, but growth is by far the most powerful anti-poverty strategy.

Sweden, a country that Labour politicians sometimes point to as a model, illustrates this point. In 1850, Sweden was a poor developing country where people starved. The country couldn't be saved by redistribution. Even if you levelled out all incomes, the average Swede would have had a standard of living equal to the median income in today's Kazakhstan.

But within a few decades, the adoption by Sweden of what we would today call free-market and outward-looking policies produced rapid industrialisation and economic growth. Until the first World War, public spending was kept below 6 percent of GDP and it remained modest for several decades. By 1970, Sweden was the fourth richest OECD country.

But over the last 30–40 years, increasing public spending, high taxes, stringent labour market regulation and a redistributionist welfare state have made the Swedish economy comparatively less productive. Sweden is not the fourth richest OECD country any longer but the seventeenth – only three rungs higher than New Zealand. This has hurt the least well off in Sweden most. Swedes were recently shocked by a study that found that if Sweden left the European Union and joined the United States it would be the poorest state of America. The study also found that the ordinary Swedish household now has a lower standard of living than its African-American counterpart. Because Sweden is a bit richer than New Zealand the same comparisons are true for us.

Sweden's relative rise and decline mirrors New Zealand's. It illustrates the effect of apparently quite small differences in rates of economic growth over a generation or two. You can figure out approximately how long it takes a country's average income to double by dividing the growth rate into the number 72. With a growth rate in real GDP per person of 2 percent a year, a country's average income doubles in 36 years. With growth of 4 percent, it doubles in 18 years.

Contrary to statements you sometimes hear, the New Zealand story is not one of declining average incomes – real GDP per head has continued to grow decade by decade, and average living standards today are much higher than those of our parents and grandparents. Rather, the story is that for many years other countries did better than New Zealand and our relative position fell. However, contrary to some other statements, this has not been a continuous trend. Following the economic liberalisation of the 1980s and early 1990s, New Zealand's average growth rate in the 10 years to 2002 improved to 3.3 percent, according to International Monetary Fund figures, which was better than the European Union average of 2.6 percent and the same as the strongly performing US economy. So New Zealand has probably stabilised its fall down the OECD rankings but, unlike Australia – which achieved average annual growth of 4.1 percent in the same decade and is now in eleventh position – it has not begun to climb up the rankings. Indeed its performance has fallen away again in recent years.

Could we get back into the high-income bracket if New Zealanders and political parties really decided that growth matters? Without a doubt. Economic research points clearly to the fact that the economic performance of a country depends primarily on the institutions and policies it adopts. One recent study suggests that they account for approximately 85 percent of the disparities in incomes between countries. Its findings contradict those who believe the government must play an active role in attracting foreign investment, promoting international trade or fostering innovation. Instead, the authors conclude that once the proper legal, economic and political environment has been created, the government's job is largely done and it should concentrate on maintaining a level playing field and treating all citizens equally under a stable and just set of rules.

Research also suggests that factors such as a country's population size, location and endowment of natural resources are much less important in explaining differences in economic performance. Ireland's location hasn't changed in the last 15 years, nor is its population size very different to ours. Yet Ireland has gone from being one of Europe's poorest economies to one of its richest – its average annual growth rate in the last 10 years was 7.9 percent – not by picking industry winners, as is sometimes thought, but primarily by adopting orthodox market-oriented policies.

Building prosperity is not easy. Growth requires a willingness to accept change, including the costs of change. Governments that promise faster growth from do-nothing, 'steady-as-she-goes' policies are in the snake oil business. If they preach prosperity while practising corporate and social welfare they will get the fruits of what they practice – stagnation and state dependency – not what they preach.

There are competing views about how New Zealand can get back into the top half of the OECD rankings. The New Zealand Business Roundtable and much of the business community have been arguing that New Zealand needs to move more in the direction of countries like Ireland, Australia and the United States – which is the same direction as that which led to Sweden's and New Zealand's earlier success. The OECD countries in general are continuing to pursue market-oriented, economically liberal policies involving stable prices, restrained government spending and regulation, lower taxes, openness to international trade and capital flows, and a greater role for the private sector, including in areas like health and education. Even so-called 'Third Way' advocates say much the same thing. London School of Economics director Anthony Giddens has written:

> Public policy has to shift from concentrating on the redistribution of wealth to promoting wealth creation. Rather than offering subsidies to business, government should foster conditions that lead firms to innovate and workers to become more efficient in the global economy.

The government disagrees, despite its 'Third Way' rhetoric. It has consciously moved in the opposite direction, involving greater government intervention and less economic freedom. It has argued that New Zealand can achieve sustained per capita economic growth of 4 percent plus even though no other country with public spending equal to 40 percent of GDP – approximately New Zealand's level – has managed to do this. So far there is no sign in any economic forecasts, including its own, that the economy is on a path to achieving the government's goals, but it argues that it is too early to tell.

The business sector and the media must do a better job of promoting a more informed public debate on policies for growth. New Zealand continues to waste resources on a grand scale – the plans for transport projects in Auckland are just the latest example. We cannot hope for growth and innovation when resources are poured into low-return projects, thousands of people are unnecessarily on benefits rather than in work, high levels of government spending and taxation crowd out the private sector, firms won't expand and take on new workers because of employment and planning laws, and government monopolies like health, education and accident compensation are shielded from competition. These are all a recipe for moving down, not up, the OECD rankings.

Many of us in the business community hope that in its new term of office the government will be more receptive to the views business people and organisations like the OECD have been putting forward, and will change direction. If it doesn't, the merits of the competing viewpoints will soon be apparent. Two terms of office is enough to make a difference. The minister of finance has agreed that the next two years will show if the government's policies are putting New Zealand on track to achieving sustained annual growth of at least 4 percent. The best scenario for the country by the time of the next election would be the kind of consensus on economic directions that countries like Ireland have achieved. If that doesn't happen, the economy and its future directions will surely be centre stage in the election debate next time round.

ARTICLE BY RODERICK DEANE FOR
THE NEW ZEALAND HERALD

STABLE PRICES THE BEST RECIPE FOR GROWTH

13 AUGUST 2002

STABLE PRICES THE BEST RECIPE FOR GROWTH

Remember inflation? In the 10 years to 1984, New Zealand's average inflation rate was 13.3 percent. The average annual growth rate was 1.5 percent.

In the 10 years to 2002, inflation averaged 1.9 percent. Economic growth in this period averaged 3.3 percent a year.

Hardly a story that inflation is good for growth – although many other factors influence the economy's performance. Achieving low inflation is one of the indisputable benefits of the post-1984 economic reform programme.

Inflation didn't happen by accident. It happened because there were always calls from some quarters to ease interest or exchange rate pressures or temporarily boost the economy. All too often governments succumbed to them.

There is now a strong professional consensus that the best contribution monetary policy can make to growth is to maintain stable prices. There is also solid support for the independence granted to the Reserve Bank of New Zealand (the Bank) in 1989. It operates entirely within rules set transparently by elected governments, but is responsible and accountable for operating decisions. Successive governments, including the present one, have shown a commendable commitment to this monetary policy framework and it is important that this commitment does not weaken.

In practice, the Bank's main function of achieving and maintaining price stability was defined up to 1996 as being to keep inflation within a 0–2 percent band (although short-term movements outside the band were always regarded as tolerable). This band, which is the same as that laid down for the European Central Bank, reflected the fact that there is a measurement bias of perhaps 1 percent in the Consumers Price Index (CPI) – so that a 1 percent CPI increase could be consistent with a stable general price level – and that monetary policy cannot hit a precise target.

Some argue that a 0–2 percent range is too confining. As an Opposition member, the minister of finance, Dr Cullen, proposed a –1 to +3 percent range. The Policy Targets Agreement negotiated with the incoming government in 1996 established the current 0–3 percent band.

There is no apparent desire to change this band, but suggestions have been made that the Bank should be instructed to operate "more flexibly" within it.

It is hard to accept that the Bank has been inflexible. More often than not inflation has been in the top half of the target range in the past 10 years. Recently, the average rate has been nearer 3 percent and inflation expectations have nudged higher.

The Bank has sometimes been accused of being 'trigger happy' in raising interest rates. With hindsight, there will always be errors of judgment with monetary policy, but central banks are often unfairly criticised for "taking away the punchbowl just as the party is getting going", to use Alan Greenspan's words.

Nevertheless, in the interests of businesses and the export sector in general it is important that the Bank is mindful of the need to avoid undue exchange rate volatility and to be sensitive to improvements in the underlying growth capacity of the economy that we all want to see.

For these reasons, there would be merit in adopting the suggestion of Professor Lars Svensson, who reviewed monetary policy last year, that the inflation focus in the Policy Targets Agreement should be on the medium term.

That should not mean an increase in the average inflation rate, however. An average CPI increase of, say, 2.5 percent over a 10-year period would mean prices would rise by about 28 percent, which is hardly consistent with price stability. It could mean a significant transfer of income from savers to borrowers.

It would also arguably harm growth. We should remember that New Zealand became one of the world's highest income countries in a period when inflation was as often negative as positive – the Consumers Price Index was at the same level in 1933 as it was in 1860.

Higher average inflation would inevitably mean higher interest rates and a higher cost of capital for New Zealand firms. Moreover, it requires just as much monetary pressure to contain inflation at a low, stable rate as at a stable, higher rate.

As a small, remote economy, New Zealand needs every competitive advantage it can get. The benefits of price stability to international competitiveness and growth are too large to be thrown away. While there may be scope for minor improvements in monetary management, these must not be a distraction from the main game which is to achieve better growth by increasing productivity.

The Reserve Bank's job could be made easier by focusing on improvements in other policies that would reduce inflationary pressures and promote growth. These include lower government spending, reduced taxation, reforms to local government to curb rate increases, the removal of tariffs, more flexibility in the labour market rather than less, more competition in sheltered sectors such as accident compensation and health, more private sector involvement in infrastructure provision, changes to the Resource Management Act 1991 to remove roadblocks to sensible development, and less rather than more regulation generally.

The business sector's focus should be on these and other growth policies to support the government's objective of lifting New Zealand's position in the Organisation for Economic Cooperation and Development (OECD) income rankings.

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ARTICLE BY ROGER KERR FOR
THE AUSTRALIAN

ECONOMIC DEBATE WILL RETURN TO CENTRE STAGE

29 JULY 2002

ECONOMIC DEBATE WILL RETURN TO CENTRE STAGE

The re-election of a Labour-led government in New Zealand is likely to see political debate refocus on the country's economic directions in the next parliamentary term.

New Zealand's economic performance over the past decade has been far from unimpressive. According to International Monetary Fund figures, annual economic growth in the 10 years to 2002 averaged 3.3 percent. The strongly performing US economy also averaged 3.3 percent growth; Australia out-performed both countries with growth of 4.1 percent a year.

The economy did better in the first half of the decade than the second, but since a Labour-led coalition took office at the end of 1999 growth continued at around 3 percent a year, despite the international downturn. The result owes much to the ongoing benefits of the structural reforms implemented in the 1980s and early 1990s. Favourable export prices and easy monetary conditions, including a low exchange rate, contributed to it.

This enabled Labour to stake a claim that it had provided stable government and competent economic management. Much of the electorate was in a comfortable frame of mind. There was no sharp focus on the economy in the election campaign; opposition parties mainly highlighted other issues.

The reality is somewhat different. New Zealand has been drifting for the better part of a decade. Contrary to the hopes of some, the move to a proportional representation voting system in 1996 did not serve to reverse the country's economic reforms; rather it locked them in but added to the paralysis. Despite its criticisms of 'neoliberal' policies, Labour in office has left most of them in place. However, it has taken backward steps rather than pointed New Zealand in the direction of more successful countries, including Australia.

The outlook is for more of the same. The business community is worried by the prospect of further re-regulation of the labour market, weaker monetary and fiscal policy and additional environmental constraints, including ratification of the Kyoto Protocol. There is no appetite among the governing parties to reduce spending and tax burdens, privatise government enterprises, introduce more competition and private sector involvement in health, education and infrastructure provision, and address New Zealand's high levels of welfare dependency.

The risks for the country are not a return to serious economic difficulties but ongoing under-performance. There is no constituency for going back to heavily interventionist policies. These characterised all the main political parties 20 years ago but the country has since moved a long way. Perhaps the most significant feature of the election is the demise of the Alliance, with only the Green Party (which barely increased its vote to around 7 percent) now remaining as the standard-bearer for inward-looking and anti-market policies. In addition, Helen Clark's government has moved in a centrist direction since assuming office, and the electorate has reinforced that shift with support for the centrist United Future Party.

The interesting question is what direction the economic debate will now take. Despite voters' comfort level and aversion to change, there is an underlying feeling that New Zealand should be doing better. This is reflected in Helen Clark's rhetorical shift from a redistributionist, 'closing the gaps' agenda to one focused on economic growth, partly in reaction to business sector criticisms of her government's early initiatives.

The prime minister has now firmly nailed her colours to the mast of getting New Zealand into the top half of the Organisation for Economic Cooperation and Development (OECD) rankings – roughly the position occupied by Australia, whose average per capita income exceeds New Zealand's by about 30 percent. The business community is sceptical that this goal is credible without major changes to the government's programme in a more liberal direction. This is not impossible for a centre-left government, as experience in Australia and elsewhere has shown. British prime minister Tony Blair has remarked that the dividing line in modern politics is not between left and right but between parties that are reformist and those that are not.

For its part, the main opposition party, National, has so far not used its time out of office well. It went into the election with a better economic programme than the government but then put forward some inconsistent policies, which created confusion as to what the party really stood for. Hopes will be pinned on former Reserve Bank of New Zealand governor, Don Brash, who was elected on the party list, contributing to a clearer vision, and on efforts by the centre-right parties to identify the common principles of an alternative programme to offer voters and challenge the government.

Going forward, the government's weakest point is the gap between its ambitious economic goals and the lack of any evidence that it is on a path to achieving them. Finance minister Michael Cullen has argued it is too early to judge results. However, he has acknowledged that "there's a great deal more work to be done" and said that the next two years will show if New Zealand is on the right track. By the next election there will be no room for excuses. 'It's the economy, stupid' is likely to be the central issue. Given the messy experience to date, there is also likely to be mounting pressure to give the public another say on the voting system.

WELLINGTON NORTH ROTARY CLUB

'BE MORE LIKE AUSTRALIA'

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

WELLINGTON
25 JULY 2002

'BE MORE LIKE AUSTRALIA'

During the election campaign we heard a lot of claims about "the failed policies of the 1990s". These claims are nonsense, and they have not been effectively countered.

In the 10 years to 2002, New Zealand's annual average growth rate was 3.3 percent, according to the latest International Monetary Fund (IMF) figures.[1] This was the same growth rate as that achieved by the strongly performing US economy in the period, and above the advanced country average of 2.7 percent. This means that New Zealand is producing nearly 40 percent more goods and services than it was 10 years ago. Some failure.

By contrast, the economy grew by only 1.8 percent on average in the 10 years to 1992, compared with average growth of 3.3 percent in the IMF's group of advanced economies.

In addition, our employment growth has been much stronger in the past 10 years, the unemployment rate has been cut in half, productivity has improved, inflation has been curbed and public debt is now much lower.

The economy's performance was strongest in the first half of this period. Real gross domestic product (GDP) per head increased by a remarkable 13 percent (calendar year basis) in the five years to 1996. Subsequent economic performance has slipped with the end of a reformist programme after the 1993 election, the advent of the Mixed Member Proportional (MMP) electoral system and large increases in government spending, as well as adverse events such as the Asian economic crisis.

However, it is not my intention today to elaborate on this analysis, or on the strengths and shortcomings of past policies. The reality is that most of the reforms have been broadly accepted and remain in place. For all the criticism, the present government has only modified a few of them in limited ways, though regrettably most of the changes have, in my view, been in the wrong direction. Rather than rake over the past, I want to look at the more important and practical issue of where New Zealand should be heading now.

On this there would appear to be considerable common ground between both supporters and critics of New Zealand's reforms. Even the critics argue that New Zealand should 'be more like Australia'. That prescription is also in line with the advice that the Organisation for Economic Cooperation and Development (OECD), the IMF and others have given to the government.

Australia has certainly done well since it embarked on a programme of structural reforms with the election of the Hawke Labor government in 1983. According to the same IMF source that I quoted earlier, Australia's economy grew by an average of 3.1 percent in the 10 years to 1992 and by 4.1 percent in the decade to 2002. Australia looks likely to continue to achieve annual growth of 3–4 percent a year whereas New Zealand's outlook is perhaps 2–3 percent. This is a significant difference. So it is certainly worth looking at lessons from Australia's experience.

To do so adequately would require a long narrative, but let me give you a quick sketch. The parallels with New Zealand are striking, but there are some important differences.

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[1] International Monetary Fund (2001), *World Economic Outlook*, Washington, DC, October.

A century ago, average Australian and New Zealand incomes were among the highest in the world, along with countries such as the United States, Britain and Argentina. Both countries had achieved their wealth with open economies, governments that were small by today's standards, and the development of resource and land-based industries that reflected their comparative advantages.

From the early part of last century, however, policies in both countries became more inward-looking. Tariffs were imposed, followed by import quotas. Labour markets were regulated and centralised wage-fixing was introduced. Government ownership of industries expanded, as did state welfare from the 1930s. By the middle of the century the terms 'fortress Australia' and 'fortress New Zealand' were being widely used.

In the post-war years, the effects of poor economic policies started to become apparent in both countries. The familiar talk about 'slipping down the international league tables' began around this time. A 1962 Monetary and Economic Council report noted that New Zealand had the worst productivity record of any advanced country since the war.

The degree of slippage was somewhat less in Australia than New Zealand. Bad policies had not been taken as far, and Australia made earlier efforts to reverse the slide. Most import quotas were eliminated in Australia in the 1960s, and tariffs were cut by 25 percent by the Whitlam government in the 1970s. Nevertheless, both countries suffered from so-called 'stagflation' in that decade as the Fraser and Muldoon governments persisted with inward-looking, big-spending and inflationary policies. New Zealand was more affected than Australia by Britain's entry into the European common market.

The real changes began in Australia with the election of the Hawke government in 1983. It is instructive to look at events from that time to the present a little more closely.

Reacting to the mess inherited from the Fraser government, the Hawke government began a radical break from the past. It floated the exchange rate, deregulated interest rates and progressively freed up the financial sector. Quota restrictions were removed and a programme of tariff reductions was put in place. Industry regulation and subsidies, including a lot of agricultural marketing regulation, were scaled back. Commonwealth spending was cut from 30 percent of GDP at the time of the last Fraser budget to 24 percent by 1989. Budget surpluses were achieved towards the end of the decade, although the gains were later squandered. Tax reforms, including an imputation system for company tax, were introduced.

These changes were generally supported by the Liberal Party, which was ashamed of its previous record. Australia had the good fortune to enjoy a government and an opposition that were prepared to accept some basic economic realities.

The main unreformed area was the labour market. The Hawke government promoted a tripartite corporatist 'Accord' with unions and employers to limit prices and wages. Critics of New Zealand's labour market reforms argued for a similar approach here, but the Accord didn't work and has long since been abandoned.

The Keating government, elected in 1993, extended the reform programme with more corporatisation and privatisation, some further tax reform and a national competition policy aimed at reducing barriers to competition in internal markets. The Kennett government in Victoria pursued a more radical programme, drawing heavily on New Zealand experience, to reverse the fortunes of what had been a declining state. Over the 1990s most other state governments moved on broadly parallel paths at a slower pace.

On its election in 1996, the Howard government faced a deteriorating fiscal position, and one of its main achievements has been to restore and largely maintain budget surpluses. It has also put in place disciplines along the lines of our Fiscal Responsibility Act 1994 and Public Finance Act 1989. The government has implemented several packages of workplace reforms that have largely decentralised employment relations and wage fixing, continued with privatisation, and introduced a goods and services tax (GST). Australia has followed New Zealand in giving its Reserve Bank an explicit inflation target. The two central banks now operate monetary policy on a very similar basis, particularly since our bank followed Australia's in using an official cash rate as its main monetary lever.

Looking at the period since 1983 in the two countries as a whole, I think the following general points stand out.

First, the fiscal and monetary stabilisation and structural reform programmes have been remarkably similar in the two countries, although the timing was often different. Some of New Zealand's reforms have been of higher quality than Australia's, which suffered in some cases from political compromises – GST is a case in point.

Secondly, Australia's programme was more gradual than New Zealand's, which was largely concentrated in the Lange–Douglas and Bolger–Richardson periods, but Australia had less long-term economic damage to undo and did not have to confront an economic crisis. People will continue to debate the merits of speed versus gradualism, which is as much a political as an economic issue, and is in any case largely irrelevant to future policy choices.

Thirdly, and perhaps most importantly, there has been more continuity in Australian policy. The political consensus for change has been stronger, and there has been limited backsliding despite changes of government at federal and state levels. Indeed, by contrast with New Zealand's record of stop-start reform and U-turns in policy direction, Australia has adopted a remarkably consistent, coherent and credible strategy of economic reform over the last two decades. Australia and New Zealand have both achieved high (and similar) rankings in the international indexes of economic freedom, but Australia is continuing to move up the rankings whereas New Zealand is moving down. This is not a good augury – economic freedom and economic performance are closely related. Ill-judged tampering with a country's economic constitution comes at a high price, particularly in respect of business investment.

Few observers doubt that Australia's improved economic performance is primarily as a result of the post-1983 reform programme, just as New Zealand's earlier reforms explain much of New Zealand's recent growth and the Thatcher reforms turned around Britain's economy. Advantages Australia enjoys that some people point to, such as its larger market size, plentiful natural resources and broader industry structure, did not prevent its earlier relative decline. And I know of no reputable commentator who attributes Australia's success to 'hands on' industry policies.

Overall, my judgment is that Australia's economic framework is in better shape than New Zealand's, and has been for some time. New Zealand possibly had an edge in some areas in the early-to-mid-1990s, and was outgrowing Australia in that period, but Australia is now better placed to prosper.

Of the policy areas that are most important for economic performance, I would say there is little difference between New Zealand and Australia today on monetary policy, financial market regulation, trade policy (tariffs are at similar levels) and regulation of most product markets. New Zealand possibly retains an edge on labour market regulation. However, the gap is narrowing and the federal government is trying to deregulate further while New Zealand is going in the opposite direction. For example, unions now have a monopoly on negotiating collective agreements in New Zealand whereas more than 10 percent of collective agreements in Australia are negotiated without union involvement.

By contrast, I think Australia has the edge in several key areas.

- Total government spending, and hence the overall tax burden, is considerably lower in Australia than in New Zealand as a proportion of the economy. Even though Australia has governments at federal, state and local levels, the ratio of total government spending to GDP is around one-third in Australia compared with around 40 percent in New Zealand. High spending and taxation levels are a drag on any economy. New Zealand simply cannot achieve sustained 4 percent plus growth rates, as advocated by most of our political parties, with so much lead in its saddlebags.
- Australia has been one of the world's most active privatisers in recent years, whereas, uniquely in the OECD, New Zealand has halted privatisation and made some opposite moves. With the sale of Sydney airport and the prospective sales of its remaining stake in Telstra and Medibank Private (a health insurer similar to the Accident Compensation Corporation), the federal government will own only one significant business, Australia Post. State governments, all of which are now Labor, have also sold many businesses, including many electricity assets and some ports.
- Australia is well ahead of New Zealand in operating infrastructure industries like roading and water on a commercial basis, with toll roads, public–private partnerships and user charges.
- Australia relies on private funding and provision of health and education to a greater extent than New Zealand. Over 30 percent of Australian children attend non-government schools, compared with around 4 percent in New Zealand (15 percent if integrated schools are included). Many of the state governments are actively extending the role of the private sector. The Labor governments in New South Wales and Victoria, for example, are looking to channel private money into public schools and hospitals, as well as public housing.[2]
- Australia's welfare arrangements are generally tighter and relatively less costly than New Zealand's. Its retirement safety net is targeted, not universal, with both income and assets tests. (By contrast its compulsory superannuation regime and tax concessions are not attractive polices in my view.) Only two-thirds of spending on retirement incomes, health and education in Australia is government spending, compared with almost 80 percent in New Zealand.

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2 'Going private: a $20b shake-up', *Australian Financial Review*, 11 February 2002.

If New Zealand were to 'be more like Australia' to lift its economic performance, I believe these are the main areas that stand out. We would also do well to study features of Australia's culture that are more favourable to business 'battlers' and entrepreneurial wealth creation.

Currently, New Zealand is moving in Australia's direction in few, if any, of the key policy areas. Instead, it is adopting elements of Australian business law, which is generally more restrictive and costly, at a time when Australia is looking at moves in the opposite direction, at least with its equivalent of our Commerce Act. Nor do I think the adoption of a common currency would have much to offer New Zealand given its present policy settings – Tasmania's experience certainly shows that a common currency is no silver bullet.

Australia is into its eleventh year of economic expansion, outperforming other major industrialised economies. As a recent editorial in *The Australian* put it, this record:

> … is a legacy of the economic reform agenda kick-started in the mid-1980s by the Hawke–Keating governments, then taken up by John Howard and Peter Costello. Liberalising much of the domestic economy and opening it up to global competition has produced results. As a nation, we should pause to reflect what would have happened without this reform agenda of the 80s and 90s. We all would be much poorer. Unemployment and inflation both would be higher. The sharp fall in the $A would have fed into a vicious cycle of higher inflation rather than been absorbed as a boost to national competitiveness. We would have had much less to spend on social services such as health, education and roads. The poor would be much worse off.[3]

With its more comprehensive set of economic reforms, Australia has reversed its long-run downward trend in relative living standards. New Zealand has at best stabilised its fall down the OECD rankings – its growth outlook is similar to that of many European economies – but it is not catching up.

Small differences in growth rates can make a big difference over time. At NZ$57,000, average Australian incomes are already 30 percent higher than New Zealand's average of NZ$44,000 on a purchasing power parity basis. If GDP per person grew by 3 percent in Australia but only 2 percent in New Zealand, the gap would widen to 44 percent over 10 years and 59 percent over 20 years. The relative attractiveness of Australia as a place to work and do business would increase further; there would be a giant sucking sound as firms and mobile New Zealanders migrated across the Tasman.

Australia does not look like resting on its laurels. The Howard government was re-elected last year, and the Labor Party, which put forward a somewhat backward-looking programme, is now in considerable disarray. Even though its record on economic reform in its last term was mixed, the government seems likely to press on. Prime minister Howard told a German audience earlier this month that "once a government loses some of its appetite for economic reform, it loses some of its rationale for existence". If and when John Howard steps down in favour of Peter Costello, there may be a new impetus to reform. Many business and media voices in Australia are calling for a more vigorous programme.

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3 *The Australian*, 11 March 2002.

Instead of moving in Australia's direction, New Zealand is by and large moving further apart in economic policy and other areas. Australians seem to see this more clearly than New Zealanders. One commentator recently wrote:

> Australians need only look across the Tasman to New Zealand to see what happens when you open up an economy, and then retreat.[4]

Another said:

> We are right to shun identification with our under-achieving and unreliable cousins across the Tasman.[5]

New South Wales Labor Premier Bob Carr was recently reported as follows:

> Carr does not want Australia to replicate New Zealand Labour's performance – a strategy, he says, that has turned back from economic competitiveness.[6]

There have been many similar comments. Other policy differences between New Zealand and Australia – from defence issues, to the Kyoto Protocol, to the approach to a free trade agreement with the United States, where Australia wants to go it alone – are also affecting the wider relationship. These are not happy developments.

Perhaps the final point to make is that Australia is no copybook example of economic management – it could be doing much better. For example, it badly needs more labour market reform to lower its unemployment rate; its high marginal tax rate and the Australian Wheat Board monopoly are absurd policies; and it is prone to 'Think Big' style indulgences with major projects. Moreover, New Zealand should be striving for superior policies to Australia to offset its disadvantages of size and location – although these should not be overstated. Instead there has been general policy deterioration since the early-to-mid-1990s. With the exceptionally favourable circumstances of the last couple of years, the economy should have been growing by 5–6 percent a year as it was in 1993 and 1994. Regrettably, with the weaker policy framework, we have been getting only around 3 percent growth, and New Zealand is showing no signs of moving back up the OECD league table.

In the election campaign there has been a lamentable absence of debate about the fundamental economic direction of the country. Australia's policy direction is in line with mainstream OECD practice: New Zealand is going the opposite way. Can New Zealand really succeed by walking a different path from the rest of the world? In the next parliamentary term, it must be hoped that political parties will be challenged more vigorously to adopt policies that match their goals. 'Being more like Australia' is not the ideal policy prescription but in many respects it would be a very good start.

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4 George Megalogenis, *The Australian*, 18 February 2002.

5 Greg Sheridan, *Dominion Post*, 22 July 2002.

6 *Australian Financial Review*, 29 January 2002.

ARTICLE BY ROGER KERR FOR
THE NEW ZEALAND HERALD

CLEARING THE PATH FOR SUSTAINED GROWTH

17 JANUARY 2002

CLEARING THE PATH FOR SUSTAINED GROWTH

This year, it seems likely that the focus of all the main business organisations will be on economic growth, and government and opposition parties' plans for promoting it.

Increases in national income, underpinned by increases in productivity, are ultimately the only means of achieving higher living standards for the community at large and funding essential government services.

Projections suggest the economy may grow by around 2 percent in 2002 – more than many other countries given the current international slowdown but only two-thirds of Australia's projected growth of around 3 percent.

The relatively good performance of Australia and New Zealand owes much to the sometimes painful economic reforms implemented in both countries over the past 15 years. Policy changes take many years to produce their full effects.

However, the government's December 2001 Economic and Fiscal Update (DEFU) suggests that over the current parliamentary term, total economic growth in New Zealand will only match that of other countries belonging to the Organisation for Economic Cooperation and Development (OECD). This contrasts with the 10 years to 2000 when New Zealand's average growth rate at 3.1 percent was slightly above the OECD average and the five years to 1996 when New Zealand averaged 4 percent annual growth.

In other words, New Zealand is only keeping pace with other OECD countries, after a period of catch-up. We are not making progress towards the government's goal of restoring New Zealand to the top half of the OECD income rankings.

Modern economic research clearly indicates that the differences in countries' long-term economic performance are primarily as a result of the quality of their policies and institutions, such as their laws and systems of government.

New Zealand has altered its economic framework in a more liberal direction, but it does not stand out from OECD norms. To catch up, it needs superior polices and institutions.

For example, the share of government spending in national income is around 40 percent – higher than the OECD average. New Zealanders spend two days in every week working for the government. This blunts incentives for growth.

No country has achieved sustained per capita income growth of 4 percent – as targeted by the government – with government spending at 40 percent of gross domestic product (GDP). A key test of the credibility of all parties' plans to achieve faster growth will be their commitment to reduce this ratio.

Pro-growth government policies include its moves to deregulate producer boards and the pharmacy industry and to pursue a free trade agreement with the United States. But its moves in areas such as employment law, accident compensation, taxation and industry regulation have been negative for growth.

Planned moves for 2002, which many business organisations view with concern, include:

- ratification of the Kyoto Protocol on climate change ahead of our trading partners;
- local government initiatives that would give councils expanded roles and subject them to weaker financial disciplines;
- further employment law changes covering health and safety, redundancy provisions and parental leave; and
- tertiary education policies, which are set to become more centralised, with less autonomy for individual institutions.

In addition, little progress is apparent on the McLeod review of taxation, the Resource Management Act 1991 and business compliance costs, and government spending limits are under pressure with health board deficits and the ill-conceived superannuation fund.

Despite favourable external conditions, farm incomes at 30-year highs and a low dollar – a sign of economic weakness rather than strength – New Zealand's balance of payments deficit is still over 3 percent of GDP at a time of modest growth, and the DEFU projections for future rates of growth in GDP (averaging between 2 and 3 percent a year) show no signs of improvement.

The government has set store on delivering on its commitments. Arguably the most important commitment for which it should be held accountable at election time is to increase New Zealand's growth rate to restore average per capita incomes to the top half of the OECD range.

The economy's performance in this parliamentary term is largely the product of past policies and cyclical factors. Changes made by the government will impact in coming years. Future projections including its own will reflect whether the government's policies are helping or hindering growth and putting the economy on track to achieve its target.

Other political parties have also set more ambitious goals for New Zealand. To date, most have not put forward programmes that would achieve them. The economic debate at election time should focus on which parties have the most credible programmes to achieve feasible goals and avert the risks for New Zealand of Tasmanian-style economic backwardness.

ROTARY CLUB OF WANGANUI

AGENDA 2002:
AN ELECTION WITH VISION

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

WANGANUI
28 JANUARY 2002

AGENDA 2002: AN ELECTION WITH VISION

Arguably the most important commitment the government has made is to restore New Zealand to the top half of the Organisation for Economic Cooperation and Development (OECD) income rankings. It has set store on keeping its word. At election time this year the main focus of the economic debate should be on whether the government is delivering on this commitment.

Past governments have made similar commitments but failed to live up to them. The Bolger–Birch government set a goal of achieving an average annual growth rate of 3.5–5 percent for the period to 2010. However, it never seriously put in the hard yards needed to achieve this goal, and neither it nor the subsequent coalition government ever looked like reaching it.

It is easy to be cynical about such lip-service commitments. But the price we pay for cynicism is to tolerate ongoing economic under-performance. This year the media, business organisations and others must hold political parties accountable for their record and their programmes in relation to goals of faster economic growth.

The Treasury has estimated that to achieve the government's goal of restoring New Zealand to the top half of the OECD ladder over 10 years, real per capita gross domestic product (GDP) would need to grow at an annual rate of 4.6 to 7.4 percent, depending on the measure of GDP that is used. The National Party has committed itself to an annual growth target of 6 percent. The ACT and New Zealand First parties have similar goals. Thus, most political parties are seeking major improvements to New Zealand's present economic performance. In doing so they are clearly reflecting the aspirations of most New Zealanders for faster increases in living standards.

The government acknowledged in the 2001 budget that "our medium-term growth path is not sufficient to improve our relative standing among the developed nations of the world". But is it on track to improving that outlook? Regrettably, no. The December 2001 Economic and Fiscal Update (DEFU) suggests that over the current parliamentary term, total economic growth in New Zealand will only match that of other OECD countries. The DEFU projections for future years (averaging between 2 and 3 percent a year) show no signs of improvement. This contrasts with the 10 years to 2001 when, according to International Monetary Fund (IMF) figures, New Zealand's average growth rate at 3.1 percent was slightly above the advanced country average of 2.8 percent, and the five years to 1996 when New Zealand averaged 4 percent annual growth. Our performance is deteriorating, not improving.

This may come as a surprise to some. Many economic commentators have seen the last three years as relatively buoyant. Growth was 5.5 percent in calendar 1999 and has averaged around 2.5 percent in the subsequent two years. But as the minister of finance noted in the budget, New Zealand has been experiencing the most benign combination of circumstances seen for many years. They include a strong world economy in that period, high commodity prices, favourable weather and a low dollar, all of which have boosted farming and some other export industries. None of these circumstances is likely to last.

Projections suggest that the economy may grow by around 2 percent this year – more than many other countries given the current international slowdown, but only two-thirds of Australia's projected growth of over 3 percent. Moreover, the balance of payments deficit is still over 3 percent of GDP at a time of modest growth, and external debt levels remain high. The improved competitiveness position is largely as a result of the weak currency, which has meant cuts in real wages. The unemployment rate seems stuck in the 5–6 percent range, contrary to the prime minister's goal of getting it down to 3 percent. Welfare dependency remains a major problem. There is little evidence to suggest that New Zealand is on its way to becoming a top OECD country. Last year the international editor for *The Australian*, Paul Kelly, expressed the view that New Zealand faces "pervasive economic decline". Such opinions are much more common in the Australian media than our own.

It is pleasing that the government (and other political parties) are recognising that New Zealand needs to do better. There is no reason why we could not achieve much faster growth. In the decade to 2001, two other small economies, Ireland and Singapore, achieved growth rates of over 7 percent, according to IMF figures. Some recent Treasury work puts New Zealand's under-performance down to problems of size and distance. This defeatism is implausible – New Zealand was no bigger or closer to its main markets when it was one of the world's highest income countries. As Glenn Withers of the Australian National University told a Business New Zealand conference at the end of 2001:

> Australia and New Zealand were once global nations for which the tyranny of distance meant little. International capital flowed freely, tariffs and minimum wages were few, and regulation minimal.

What went wrong for both countries, Withers noted, was a shift from open, liberal policies to a century of protectionism and welfare statism. This bred a culture of dependence that focused on redistribution, not wealth creation. Only in the last two decades have both countries started to discard this legacy.

In its first year of office the government's emphasis was again on redistribution, with moves such as the increase in the top income tax rate and increased assistance to superannuitants and tertiary students – in the last two cases benefiting better-off groups rather than the disadvantaged. However, its subsequent declared focus, which business organisations have welcomed, has been on wealth creation. The problem is that a credible and coherent strategy, in line with contemporary economic thinking and the directions of successful countries, has not yet emerged. In the 2001 budget, the government described its strategy in the following terms:

- building the future capability of the economy by creating an economy that supports entrepreneurship and excellence;
- building the base of business through a network of incubator supports, technology fellowships and enterprise award programmes;
- attracting enterprises with high growth potential by introducing business growth and greenfields investment services;
- assisting specific sectors to develop expansion strategies in partnership with the government; and
- a 'smart government' component that expands the role of the Industrial Supplies Office and attracts and coordinates major events.

This, to be frank, is not a strategy. Nor is talk about a 'new economy' or a 'knowledge economy'. Many of New Zealand's strengths are in 'old economy' industries. Key requirements for the development of innovative, high-technology industries are high levels of economic freedom – low taxes, unrestrictive labour laws, light regulation –

and rigorous, competitive education. The government is not currently taking New Zealand in these directions.

This is not to deny that there have been a number of developments that have been welcomed by the New Zealand Business Roundtable and other business organisations. The government's monetary policy review rejected misguided proposals to change the 1989 Reserve Bank of New Zealand Act. Its tax review served a similar purpose in rejecting ideas for new taxes, but it is disappointing that its arguments for a lower, flatter tax structure were quickly dismissed. The government's commitment to stick to its spending allocations – even though they can be criticised as excessive – has been important for financial market confidence. It has held the line in the debate on genetic modification, and it also deserves credit for the deregulation of two of the three monopoly producer boards, moves on immigration and its free trade initiatives.

On the other side of the ledger, however, have been backward moves such as those on tax, accident compensation, employment law, business regulation, nationalisation, education, health and welfare. The government has made little progress with the Resource Management Act 1991 and other business compliance costs. Government operating and capital spending limits are under pressure with health board deficits and the ill-conceived superannuation fund. Initiatives in the pipeline that would be damaging to business include ratification of the Kyoto Protocol, expanded roles and powers for local government, and further employment law changes covering health and safety, redundancy provisions and parental leave. The upshot is that New Zealand's growth outlook has become weaker, not stronger – recent Treasury forecasts have consistently been too optimistic and no economists to my knowledge foresee the kind of growth rates that the government is targeting.

What does New Zealand have to do to achieve a better economic performance? The answer is pretty clear from our experience and that of many other countries over the last two decades. Economic success is not dependent on abundant natural resources. It isn't much affected by size and distance. In today's global economy it isn't solely dependent on the quality of local business skills, provided there are no barriers to outside involvement. Far more important than these factors are countries' own policies and institutions, such as their laws and systems of government.

Today's most successful countries are, in general, those that have avoided or moved away from failed policies of protectionism, import substitution, Keynesianism, central planning in its various forms and extensive state welfare, and towards a freer, open and competitive economic environment. They have fostered – not just talked about – a climate of enterprise rather than state dependency. They are also characterised by good democratic systems and respect for property rights, contracts and the rule of law.

Thus, the relatively strong position of countries like the United States, the United Kingdom, Ireland and Australia today owes much to market-oriented economic reforms that began in the 1980s. Thanks to its reforms New Zealand is also far better placed than it was prior to 1984. Yet for almost a decade New Zealand has made little further progress while other countries have continued with policies such as deregulation, privatisation, smaller government, cutting high taxes, greater competition in health and education and welfare reform. Like physical fitness, economic fitness has to be maintained. There is no point in going to the gym once every 10 years. You have to keep on keeping on. New Zealand no longer stands out from OECD norms in terms of the overall configuration of its policies. It also has the handicap of the Mixed Member Proportional (MMP) electoral system. Unsurprisingly, its performance is now no better than the OECD average.

Leading countries such as the United States are continuing to move forward – the Bush administration is reducing taxes, implementing further education and welfare policy changes and lightening burdens on businesses. The Irish economy grew by around 6 percent in 2001 and is projected to record around 5 percent growth in 2002. If it is returned at this year's elections, the Irish government is likely to continue with privatisation and tax reductions. Australia is also likely to continue on a steady reformist path both at the federal level and at the state level, where Labor governments are mostly in power. As prime minister John Howard said following his re-election:

> There is some reform fatigue, but if you continue to argue the national benefits, you can still take people with you. We don't want to lapse into the status quo.

Business organisations in Australia are pressing for ongoing change. Earlier in January the Australian Chamber of Commerce and Industry called for more moves in a free-market and smaller government direction. It argued for cuts in government spending, rolling back red tape, deregulation of the labour market (especially unfair dismissal laws) and no ratification of the Kyoto Protocol by Australia pending study of its economic impact.

Most business organisations in New Zealand have a broadly similar agenda. In 2001 the New Zealand Business Roundtable published work on the impact of high government spending on economic growth. One basic finding was that New Zealand has virtually no chance of achieving sustained per capita income growth of 4 percent or more with government spending (central plus local) equal to around 40 percent of the economy as at present. Any credible growth strategy has to target levels of 30 percent or below as found in countries like the United States, Ireland, Singapore and Hong Kong. We have advocated getting all income tax rates (personal and company) down to a maximum of 25 percent. Also in 2001 we published, along with other business organisations, a major study on constraining government regulation which, among other things, floated the idea of a Regulatory Responsibility Act.

Government spending (both central and local), taxation and business regulation will be major election policy issues for us in 2002. Other priorities will be employment law, small business growth, education and welfare (including the family), on which we shall be releasing major studies. We shall also be publishing a study on Tasmania, which illustrates the risks for a small, remote economy of persisting with bad policies and institutions.

In February, the government will be announcing a package of initiatives to advance its 'economic innovation' agenda. It is to be hoped that it picks up ideas that Reserve Bank of New Zealand governor Don Brash put forward at the Knowledge Wave conference and the representations of business organisations. Raising income levels to the top half of the OECD requires major changes to fiscal, regulatory and social policies. Tinkering and small-scale industry and science policies won't do. Whatever view one takes of initiatives such as Industry New Zealand, the Kiwibank and export credit schemes, they are simply peripheral – as of the end of last year the export credit insurance fund had received just one application. The government's dialogue with business over the past 15 months will have been fruitless if the package lacks substance and if ongoing representations on Kyoto, local government, health and safety and other legislative proposals are not heeded.

Anyone in touch with New Zealand business and international investment markets knows that New Zealand has lost ground relative to its achievements in the early-to-mid-1990s. Late in 2001, the chief financial officer of Telecom was reported as saying:

> We've lost our share of air-time [in the international investment community]. They can't even get their heads around bothering to allocate resources.

Polls indicate that many business leaders are critical of the government's directions but also feel the National Party is not offering ambitious and credible alternatives. The country desperately needs an election with vision. A strong, growing economy with vibrant, robust businesses is fundamental to the country's quality of life and a strong society. Without it we will not meet the challenges of raising personal incomes, job creation, attracting new investment, retention of our best and brightest, security for an ageing population and environmental improvement. It will be up to everyone this year – the media, community groups, business organisations and others – to insist that a Tasmanian scenario for New Zealand is simply one that cannot be tolerated.

NEW ZEALAND INSTITUTE OF MANAGEMENT
CANTERBURY DIVISION

GETTING UP THE OECD RANKINGS

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

CHRISTCHURCH
26 NOVEMBER 2001

GETTING UP THE OECD RANKINGS

One of the messages of congratulations that I most appreciated when I received the 2001 New Zealand Institute of Economic Research (NZIER) Qantas Economics Award was from an academic and former winner of the award. He wrote: "It is good to know that some people can still distinguish high quality analysis from ideological advocacy". I want to talk about some basic economic analysis today.

In particular, I want to look at what economics can tell us about the challenge of climbing back up the Organisation for Economic Cooperation and Development (OECD) rankings. This is the government's aim: in this year's (2001) budget Michael Cullen stated:

> We need to set ourselves a goal of being back in the top half of the developed world in terms of per capita GDP – a position we have not occupied since 1970.

Leaders of other political parties have committed themselves to similar goals.

Talk of achieving much faster economic growth reflects a widespread feeling that New Zealand is not doing as well as it could or should economically. The Knowledge Wave conference, for example, was fundamentally about economic growth, and how we might get more of it.

To be sure, New Zealand has made some progress. In the decade to 2001, the economy grew at an average annual rate of 3.1 percent according to International Monetary Fund (IMF) figures, better than the advanced country average of 2.8 percent and far better than New Zealand's average of 1.2 percent a year for the decade to 1991.[1] The idea that the reforms of the 1980s and early 1990s were a failure is sheer nonsense.

Over the past few years, however, little has been done to build on the earlier gains and backward steps have been taken. As a result, the economy's performance has deteriorated and the Treasury's estimates of growth have been too optimistic. In its October 1999 Update it forecast growth for the year to March 2001 of 3.5 percent; the actual figure was 2.5 percent. In its December 2000 Update the Treasury expected growth of 3.7 percent for the year to March 2002; the figure is again likely to come in at nearer 2.5 percent. For the period 2006–2011 the Treasury's projections in the 2001 budget are for average growth of only 2.2 percent per annum.

My overall assessment is that with the growth in inflation, government spending, deficits and debt during the Muldoon era, coupled with an array of economic distortions, the economy's potential growth rate was no better than 1–2 percent by the early 1980s. Following the two waves of economic reform in 1984–88 and 1990–91, it rose to perhaps 2.5–3.5 percent. With the subsequent stalling of policy reforms and the reversals of the present parliamentary term, I suspect our sustainable growth rate has fallen back to 2–3 percent per annum – say around 2.5 percent on average. This figure seems to be in line with Treasury assumptions and those of other economists.

A sustained improvement of half a percentage point a year in the economy's growth rate is very significant. Over 40 years – the working lifetime of many people – average

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[1] International Monetary Fund (2001), *World Economic Outlook*, Washington DC, May, p 204.

incomes would be 22 percent higher with such an improvement than they would otherwise be, all other things being equal. That is a major lift in living standards. Getting a shift in growth of just half a percentage point a year, however, is no easy task.

What improvement in performance would be required if New Zealand were to achieve the government's goal of restoring New Zealand to the top half of the OECD rankings? A recent paper by two Treasury economists provided some useful numbers. It estimated that in order to reach this target in 10 years, real gross domestic product (GDP) per capita would have to grow at an annual rate of 4.6 to 7.4 percent depending on the measure of GDP used.[2] This assumes that other OECD countries grow at the rates they achieved on average over the period 1970–1999.

To convert these estimates of growth in per capita incomes into the required rate of real GDP growth, we need to add about 1 percentage point to reflect likely growth in population. Thus, if the government's goal were to be achieved over 10 years, it would require economic growth to be raised from its present sustainable rate of perhaps 2.5 percent to between 5.6 and 8.4 percent on average. Let's settle for a figure towards the bottom end of that range – say 6 percent. That happens to be the growth rate that the National Party is also targeting.[3]

Achieving a sustained 6 percent growth rate is a huge ask. But we have to believe that political leaders are serious about what they say and indeed to hold them to account – the prime minister has made much of delivering on commitments. Can it be done? I think economics tells us the answer is 'yes', in principle. In the decade to 2001, two other small economies, Ireland and Singapore, achieved average growth rates of 7.1 percent and 7.2 percent respectively, according to IMF figures. But achieving such a goal would require political leadership, community consensus and outstanding economic management on a sustained basis.

Nevertheless, the stakes are very high. At a 6 percent rate of economic growth and population growth of 1 percent a year, average real per capita incomes would double in 15 years. In an open, competitive economy, those improvements would be widely shared. Think of the difference they could make to the outlook for struggling families, the quality of health and other social services, the availability of resources for enhancing the environment, and the attractiveness of the country as a place to live, work and do business.

What would we have to do to raise our economic game to this level? The answer is fairly clear-cut. Modern economic research tells us that we don't need to worry a great deal about such things as our endowment of natural resources or management skills – where these are lacking we can easily access them on world markets. Far more important is the quality of policies and institutions, including our political arrangements. One summary of the lessons from the modern growth literature lists six key rules: accumulate capital, keep government small, open the economy to foreign trade and investment, respect property rights and the rule of law, do not burden the productive sector with excessive government controls and regulation, and

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2 Peter Mawson and Grant Scobie (2001), 'Climbing the OECD Ladder: What Does New Zealand Have to Do?,' New Zealand Treasury, Wellington.

3 Rt Hon Jenny Shipley, 'Lifting incomes and lifting New Zealand', speech to National Party Annual Conference, Auckland, 21 July 2001.

invest in human capital.[4] The overriding requirement could be summed up as greater economic freedom: the link between economic freedom and growth is well-established. I don't believe there is much debate today among leading economists about this prescription.

For New Zealand, moving in this direction would require big changes, but no bigger than countries like Ireland and Singapore have accomplished. There are plenty of examples of 'good practice' policies around the world that New Zealand could emulate or indeed improve upon – as a small, remote country we need to strive for superior policies to offset our natural disadvantages. So the challenge is not insuperable: achieving it is essentially a matter of political leadership and public understanding.

How can we identify more precisely the key changes that would be necessary and quantify the general contribution they might make to achieving politicians' goals? Let me give you a personal assessment. In most cases the estimates I offer are fairly subjective. They represent my best judgment of what better policy settings might offer.

Recall that we are discussing how to raise New Zealand's average annual growth rate from around 2.5 percent per annum to around 6 percent. That is a 3.5 percentage point difference. I can think of three changes that might add perhaps 0.5 percentage points each to the growth rate and another eight that might bridge the remaining 2 percentage point gap.

Policy # 1: Lower the government spending ratio

There is little doubt that the massive increase in government spending in the Muldoon era was a major drag on the economy. Winston Peters's $5 billion spending package (subsequently slightly reduced) and the planned $6 billion increase in the current parliamentary term have had similar effects. A leading researcher on economic growth, James Gwartney of Florida State University, has recently commented that:

> New Zealand is still a big government welfare state. Government spending 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.[5]

In other words, politicians should stop talking about 6 percent growth rates if they are not prepared to reduce the size of government significantly in the economy. Winton Bates has recently estimated that a reduction in government spending of 10 percentage points (for example, from 40 percent of GDP, the present level of central and local government spending in New Zealand, to around 30 percent, the level of countries like Ireland and the United States) would add about 0.5 percent per annum to economic growth over 10 years.[6] This does not imply a 'slash and burn' attack on

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4 William Beach and Gareth Davis, 'The Institutional Setting of Economic Growth', *1999 Index of Economic Freedom*, Heritage Foundation and Wall Street Journal, p 8.

5 Quoted in Winton Bates (2001), *How Much Government?: The Effects of High Government Spending on Economic Performance*, New Zealand Business Roundtable, Wellington, p 26.

6 Bates, *op cit*.

government spending, even though there is abundant evidence of waste and poor targeting. Bates points out that if government spending is held constant in real terms – without any overall cuts – and the economy grows at just 3 percent per annum, this would result in a drop of more than 5 percentage points in government spending as a percentage of GDP over five years. So shrinking the government's share of national income is a first and essential step towards faster economic growth.

Policy # 2: Labour market and welfare reforms

I believe labour market and welfare arrangements along the lines of the United States or Hong Kong and Singapore would add another 0.5 percentage point to New Zealand's growth rate. These countries have low levels of unemployment and much less welfare dependency than New Zealand. Flexible labour markets and welfare arrangements that minimise disincentives to work are the key to these achievements. The out-performance of the United States relative to Europe in high technology industries owes much to hiring and firing rules that encourage entrepreneurs to innovate and take risks. Venture capital investors need to be able to reduce workforces easily if projects don't work out. People should be free to decide on the terms of their own contracts. United States welfare reforms have halved welfare rolls. New Zealand's growth rate would be boosted by absorbing into the labour force those who are unemployed and many other beneficiaries. As they gained skills in the workplace they would contribute to further improvements in labour productivity. A more restrictive state safety net would boost private savings, as the experience of Asian countries demonstrates. Labour market and welfare reforms would also yield benefits in the form of lower fiscal costs, less crime and improvements in other social indicators.

Policy # 3: Abandon MMP

A third reform that could deliver a dividend of perhaps 0.5 percentage point in my view would be the abandonment of the mixed member proportional (MMP) electoral system. The main argument against MMP is not economic; it is that MMP is a poor democratic system because it leads to unrepresentative outcomes, gives too much power to minority parties, leads to deal-making behind closed doors, and lacks clear accountability – it is not easy for voters to remove a government they dislike. In addition, as we have seen, MMP leads to policy paralysis, low-quality compromises on legislative measures, fiscal excesses as deals are done between coalition partners, and generally weaker government. A small country needs to be decisive and nimble in responding to external events and seizing opportunities to raise its performance. Japan's decade-long stagnation owes much to policy paralysis under an electoral system similar to New Zealand's. My own preference would be a return to a first-past-the-post system. It is absurd to regard a system born in the world's oldest democracy, Britain, and also used in the leading democratic nation in the world today, the United States, as somehow undemocratic.

The next eight policy reforms might account on average for an increment to growth of about a quarter of a percentage point each.

Policy # 4: Tax reform

The greater integration of the world economy has increased the mobility of capital and labour and imposed heavier penalties on high-tax countries. The tax burden is primarily a function of government spending but the tax structure also matters. To boost growth and 'stand out from the crowd' with tax rates that would help attract and retain capital and skilled people, New Zealand should be aiming for top personal and business tax rates no higher than 25 percent. That would still leave New Zealand rates much higher than those in Hong Kong, which has a company tax rate of 16 percent and a top rate on wage and salary income of 15 percent.

Policy # 5: Privatisation

The worldwide evidence in favour of privatisation is now compelling. As a recent survey article put it: "We know that privatization 'works', in the sense that divested firms almost always become more efficient, more profitable, and financially healthier, and increase their capital investment spending".[7] New Zealand research has confirmed that privatisation has yielded additional gains over and above those achieved from corporatisation. The argument is not that government-owned firms always under-perform and private firms succeed. Clearly there are successes and failures in both categories – both the Bank of New Zealand in public ownership and Air New Zealand this year are examples of failures. Rather, the argument is that on average and over time private firms do better, and it is this general tendency that should determine policy. At central government level the most important candidate for privatisation, partly in the interests of strengthening market competition, is electricity generation, which is mainly a private sector industry around the world. Privatisation should also include accident compensation: industry estimates put the gains during the brief period of deregulation at around $300 million. At the local government level there is no need for councils to be running ports, airports, power companies and many other commercial ventures.

Policy # 6: Commercialisation of roading and water supply

There are large gains to be made by operating roading and the supply of water on a more commercial basis. Both are very large infrastructure industries. There have been discussions about moving to more commercial models going back several years, but very little has happened. The costs to the economy of traffic congestion in Auckland have been estimated at close to a billion dollars a year. Proper pricing of roads and water supply needs to be introduced for both economic and environmental reasons. Both forms of infrastructure could remain in public ownership under commercial structures, but there is no reason to exclude private sector participation through franchising or other arrangements. Developments of this kind are commonplace around the world.

Policy # 7: Limit local government to a public goods role

Local government is a major sector of the economy. Its spending accounts for around 4 percent of GDP and its net equity is about $42 billion, well in excess of the total equity of companies listed on the stock exchange which is around $27 billion. The range of council activities is excessive and there is abundant evidence of waste and poor returns on assets. Councils should be refocused on their core role of ensuring the provision of local public goods – goods and services that the private sector can't adequately supply on a commercial basis. The government's current proposals to give councils expanded roles and powers go in the wrong direction. Local democracy is weak, as the recent low election turnout confirmed. I would favour specifying the

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[7] William Megginson and Jeffrey Netter (2001), 'From State to Market: A Survey of Empirical Studies on Privatization', *Journal of Economic Literature*, Vol XXXIX, (June), p 381.

core functions that councils should undertake, listing activities that councils would be prohibited from undertaking, and providing for a ratepayer referendum (requiring the support of, say, two-thirds of ratepayers) if councils wished to undertake functions beyond the specified core.

Policy # 8: Reform of the Resource Management Act

In a recent government review, the Resource Management Act 1991 (RMA) came out as the number one issue for businesses after taxation from a compliance cost standpoint. Overseas investors have said it is a deterrent to doing business in New Zealand. It is idle to put most of the blame for costs and delays on council officers or vexatious objectors. They are only responding to the constraints and incentives in the law. As an exercise in regulatory reform, the process that gave rise to the RMA was hopelessly flawed; a valid framework and set of guiding principles were never established. A review should be based on proper public policy criteria. It should put emphasis on the importance of secure private property rights for both economic and environmental reasons, allow takings only on established public good grounds, and provide for payment of compensation for such takings.

Policy # 9 Free trade

The previous National government took a decision to phase out remaining tariffs but this has been frozen. Tariffs misallocate resources away from activities that can stand on their own feet and into industries that are only profitable because they can raise prices to domestic consumers. They also reduce competition and stifle innovation. Because of past tariff reductions the adjustments now required on the part of protected industries to cope with full free trade are not large. Such a move would allow much of the customs bureaucracy to be dismantled, and the protectionist anti-dumping law could be replaced by normal Commerce Act rules. Other industry subsidies should also be removed. Not only do they have the same distorting effects as tariffs but they cannot possibly have a material impact on growth one way or another. Even on the most unrealistic and optimistic assumptions, I estimate that a programme of $100 million of business assistance would only boost growth by 0.033 percentage points; in all likelihood it would reduce national income.[8]

Policy # 10: Dairy industry reform

Dairying is New Zealand’s largest industry. The removal of the single desk export monopoly and the introduction of competition into the industry were long overdue. However, the industry remains highly regulated, which is a recipe for ongoing economic losses and corrosive industry politics. With the exception of simple provisions to deal with quota markets, there is no need for special legislation for dairying and the industry should be normalised as soon as possible. Little has yet been done to remove the price distortions associated with the bundling of on-farm and off-farm returns in the payout to farmers. According to one estimate, the costs of these distortions to the economy could be as high as $480 million a year.[9]

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8 See Roger Kerr (2000), ‘‘Think Small’ is no better than ‘Think Big’’, in *Can New Zealand Afford to Replay the Economic Past*?, New Zealand Business Roundtable, Wellington, p 101–106.

9 Winton Bates (1998), *Farmer Control of Processing and Marketing: Does it serve the interests of farmers?*, New Zealand Business Roundtable, Wellington, p 6.

Policy # 11 Linkages with the United States

On his recent visit to New Zealand, former Canadian prime minister Brian Mulroney spoke of the immense benefits to Canada of that country's economic links with the United States. New Zealand should vigorously pursue the idea of a comprehensive free trade agreement with the Bush administration. It should also look seriously at the idea of adopting the US dollar. This could reduce the cost of capital to New Zealand firms by as much as 1.5 percentage points and lower the transactions costs of dealing in foreign currency.[10] Even more important than the trade and investment gains could be the benefits of greater exposure to the institutions, policies and cultural attitudes that make the United States the world's most successful country.

This list of policy changes omits some that are vital to New Zealand's long-term performance. An obvious one is education. However, the reality is that the badly needed changes to move away from the public monopoly in education and introduce greater choice and competition would have little impact within a 10-year period. Reversing the dumbing down of education would take time, and most of the workforce will be unaffected by any feasible changes (although resources within the education sector would be used much more efficiently). The same goes for immigration, which is a long-term policy.

Obviously there can be arguments about the priorities I have identified, and whether the rough estimates of the contributions of the suggested policy changes to GDP growth are in the right ballpark. Equally, there are many other steps that could be taken. For example, there is a strong case for a first principles review of many regulations that are constraining business growth. A former minister of commerce estimated that New Zealand governments introduced over 1,600 new pieces of legislation and 3,600 new regulations in the past decade alone. Hong Kong is reported to have fewer than 1,000 regulations in total that affect business, and some in Hong Kong regard that number as too high. A regulatory statute along the lines of the Fiscal Responsibility Act 1994 would help to impose greater discipline on regulatory policy making.

However, I think economics teaches us that any credible programme to bridge the gap between New Zealand's present sustainable growth rate and a rate that would lift incomes to average OECD levels would look much like the one I have outlined. Some aspects of it are axiomatic: the job simply can't be done with central and local governments spending 40 percent of national income. Much more room and freedom needs to be given to the private sector. The changes required are certainly large but hardly radical; similar arrangements are in place in many successful countries, and it would be possible to improve on them in some cases. There is certainly no reason in economics why New Zealand could not become a Kiwi Tiger, as our political leaders are suggesting. But to do so we need to walk the walk. The Treasury paper I quoted earlier suggested that, on present policies, New Zealand's ranking among the OECD countries will probably continue to go down rather than up. If politicians and the community are not prepared to debate and embrace a credible programme of better policy settings to match ambitious goals, they should stop talking the talk.

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

NEW ZEALAND INSTITUTE OF MANAGEMENT
CHIEF EXECUTIVE BREAKFAST BRIEFING

BENCHMARKING INTERNATIONAL BEST PRACTICE IN PUBLIC POLICIES

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NEW ZEALAND BUSINESS ROUNDTABLE

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23 OCTOBER 2001

BENCHMARKING INTERNATIONAL BEST PRACTICE IN PUBLIC POLICIES

In businesses today it is commonplace to benchmark practices and performance against other companies, both at home and abroad. Typically, firms aspire to best practice as a yardstick, wherever this is feasible.

We can do the same thing with our public policies. While local circumstances need to be taken into account, by and large policy lessons run across countries, if only because human behaviour is much the same worldwide. Central planning doesn't work any better in North Korea or Cuba than it did in the Soviet Union. So I thought it might be an interesting exercise to see how New Zealand policies in key areas stack up against what might be regarded as best practice around the world.

The motivation for such an exercise is obvious. There is again a widespread feeling in the community that New Zealand needs to do better economically. One manifestation was the Knowledge Wave conference, which was fundamentally about faster economic growth. Political parties are talking about growth rates that would dramatically lift New Zealand's position in the Organisation for Economic Cooperation and Development (OECD) rankings.

Achieving much faster growth would require major changes in people's attitudes and behaviour, in business performance and, above all, in public policies. The quality of policies and institutions – such as secure property rights, sound political arrangements and the rule of law – is critical for economic performance; it dominates everything else.

New Zealand's economic performance improved sharply following the two waves of reform in the 1980s and early 1990s. For the 1990s as a whole, average per capita incomes grew by 1.7 percent per annum in real terms, twice the 0.8 percent rate recorded over the last three decades on average. That improved growth rate is virtually identical to that of the OECD as a whole in the last 10 years, so the reforms seem to have arrested our earlier decline. However, little more has been done for the better part of a decade, some recent moves have been negative for growth, and we are not on a path to close the gaps with higher income countries.

How should we think about policies for better economic performance, and go about benchmarking our policies with those of other countries? A few preliminary observations are in order.

First, the starting point in thinking about any policy should be the best insights from economics and related disciplines, not what other countries do. No country has an ideal set of policies and even very successful countries have many bad ones – protectionist agricultural policies in rich countries are just one case in point. Governments typically govern in the interests of particular constituencies that vote for them rather than in the overall public interest. The public interest should be regarded more as a constraint on their behaviour than a goal: if they neglect it unduly the country will fare poorly and they will lose office. Thus, it is very often possible to devise better policies by using sound economic principles than by selecting policies from a menu of those in place around the world at any point in time. There were few models 20 years ago, for example, for independent central banks or programmes of privatisation. Nevertheless, many people want to see the insights of economic thinking confirmed in practice before being persuaded by them. This is perfectly understandable. Hence the value of looking at best practice, or at least good practice, elsewhere.

Secondly, the most important benchmarks are the soundness of the overall direction of policy and a consistent economic framework. Success requires getting a lot of things right, and making continuous improvements to at least match advances elsewhere. Thus, a study by Phil Barry for the New Zealand Business Roundtable earlier this year looked at New Zealand's current public policy directions in an international context, and concluded that they are contrary to those observed in most, if not all, OECD countries over the last two decades. Indeed, David Henderson, a former senior OECD official, wrote in a paper earlier this year that "There are only a few countries where the trend is in the opposite direction: examples are New Zealand, Venezuela and Zimbabwe". Other countries have maintained programmes of economic liberalisation whereas New Zealand is swimming against the tide with moves to higher government spending and taxation, government ownership of industry, greater regulation and more 'hands on' intervention.

Thirdly, to do as well as high performing countries we have to have policies that are better than theirs, not just the same. We need to create competitive policy advantages to offset our disadvantages of size and isolation. There is little point in matching Australian tax rates or adopting Australian business regulations, for example, unless they are the best possible model: we must strive to do better. Otherwise the attractions of its larger economy will be compelling for many businesses. I think this is an uncontroversial proposition: the same point has been made by the OECD and *The Economist* in commenting on New Zealand, and echoed by the minister of finance and other politicians.

A final reason for embarking on this exercise is to challenge the view that policy changes which the New Zealand Business Roundtable and others have supported are somehow 'radical' or 'extreme'. As we shall see, policies we have advocated have been implemented in many comparable countries.

Against this background, let's benchmark New Zealand against good international practice in a range of areas that are important enough to make a difference to overall national performance. My list comprises monetary policy, public spending, taxation, privatisation, trade policy, labour markets, education and health, and welfare. I do not claim that this list is comprehensive: it does not include important institutional arrangements like the electoral system, protection of property rights or land-use regulation, for example. Nor do I claim that all the policy benchmarks I have chosen are the world's best, still less the best that could be devised. My argument is simply that they offer major advantages over New Zealand's current arrangements.

With respect to *monetary policy*, little needs to be said. New Zealand's current institutional arrangements, notably an independent central bank charged with keeping prices stable, are in line with world best practice, as are the Reserve Bank of New Zealand's operating procedures. The only medium-term alternative worthy of consideration is the adoption of a common currency, such as the Australian or United States dollar. This is a serious option, but only in the context of a much more flexible economy and perhaps a broader relationship with the United States, including a free trade agreement.

On *public spending*, New Zealand is well short of best practice. While the quality of spending matters, the total level should be related to the government's role of ensuring the provision of core public goods – such as a legal system, defence and public health – and a social safety net. Spending by central and local governments in New Zealand currently runs at around 40 percent of gross domestic product (GDP), a level far in excess of that needed to discharge core functions. I know of no country that has achieved sustained per capita income growth of 4 percent a year – the kind of rate needed if New Zealand is to move up the OECD rankings – with a 40 percent government sector share of the economy. Benchmark countries for New Zealand should be Hong Kong and Singapore, where government spending is below 20 percent of GDP, or the United States and Ireland, where it is around 30 percent. The smaller size of government in these economies is undoubtedly a major factor in their better economic and social performance.

High government spending by definition means a high tax burden. For any given level of government spending, the *tax policy* issue is how best to raise the required amount of revenue. New Zealand has a well-designed consumption tax in the form of goods and services tax (GST), but our income tax is not best practice. As the current Tax Review has argued, New Zealand should be moving to a lower, flatter income tax structure, not a more progressive one. Hong Kong is a model in this regard: it has a company tax rate of 16 percent and a top personal tax rate of 15 percent. Russia has introduced a flat income tax of 13 percent this year. New Zealand needs to 'stand out from the crowd' to attract internationally mobile capital and labour and should be aiming to get all income tax rates down to below 25 percent.

New Zealand was a latecomer to *privatisation*, but for a time made significant progress. In line with experience elsewhere, privatised firms have generally achieved productivity improvements and contributed to growth. While privatisation came to a halt and has now been reversed in New Zealand, it has proceeded apace around the world. Electricity is now mainly a private sector industry internationally whereas the state remains dominant in New Zealand. Few if any countries have a state monopoly accident insurance business. Germany is privatising its post office as well as many of its hospitals. Australia has privatised most of its airports and the South Australian government is privatising its port company and has franchised its water supply. The list goes on. Not all privately owned companies succeed and not all state-owned enterprises are failures, but the evidence is clear that, on average and over time, private firms out-perform state firms. This is the essential case for privatisation: governments should not bet against the odds.

Under the heading of *trade policy*, the case for free trade is firmly established in economics and, with some exceptions, trade barriers around the world are gradually coming down. Benchmark countries for New Zealand include Hong Kong and Singapore, which have had free trade for years. Switzerland is largely a free trader, apart from agriculture. Other small countries like Ireland and Sweden have benefited from having relatively open economies. The government's decision to freeze tariffs makes no sense from an economic perspective: the sooner New Zealand gets to free trade the better.

New Zealand went a long way in the direction of a freer *labour market* but with the re-regulation of employment arrangements by the Employment Court and the recent Employment Relations Act, New Zealand no longer stands out from the crowd. Experienced practitioners are advising companies considering whether to locate in Australia or New Zealand that Australia's labour laws overall are now better than ours. This is a huge setback, since Australia's arrangements are still far from best practice. Much better models for New Zealand are Hong Kong and Singapore, or the United States, the United Kingdom and Switzerland, whose regimes intrude much less on the freedom of parties to negotiate their own contracts. What is particularly important in new and innovative industries, such as in the high-tech sector, is freedom in hiring and firing so that firms can cut their losses and terminate contracts if risky ventures don't pay off. Many observers have remarked that the freer labour markets in the United States have given that country competitive advantages over European countries that have maintained rigid employment protection rules and suffered higher unemployment. Unfortunately, New Zealand has been heading down the European path.

When it comes to *education* and *health*, which are the source of perennial dissatisfaction in New Zealand, the key problem to focus on is the public monopoly. The government has a dominant role as owner, funder and regulator at the compulsory levels of education, and in tertiary education and secondary medical care – though not in primary (general practice) medicine, which works well. Despite the best efforts of many professionals, all the problems of monopoly are apparent in these sectors – high costs, one-size-fits-all services, queues and waiting lists, and rigid, disputatious employment arrangements. We saw impressive gains from competition when the accident compensation monopoly was briefly removed.

In respect of *compulsory education*, an outstanding model is Ireland. Most schools in Ireland are private – there is no obvious reason why the government needs to own all schools – but Irish schools are funded on more or less an equal basis. Education is traditional, teacher-centred and meritocratic, with an emphasis on external examinations. The result is a workforce that is literate and strong in maths and sciences, and thus attractive to international companies. The Netherlands, Denmark and Sweden are also countries that have avoided or abandoned a monopoly education system; they have a strong private school sector and/or roughly equal funding of state and private schools. In the United States the school choice movement continues to gain ground through charter school initiatives, voucher schemes, for-profit education and home schooling. Australia has an important private sector and out-performs New Zealand in international comparisons. Education standards in Hong Kong and Singapore are also high. A feature of these countries is the contribution of fees, particularly in higher education. Government expenditure on education is around 3 percent of GDP in Hong Kong and 2 percent in Singapore, compared with 6 percent in New Zealand.

For *tertiary education*, particularly universities, the US system as a whole is widely regarded as the best in the world (although there are, of course, weak institutions in such a large and diverse system). The key characteristics of the US system are strong competition between institutions, the important role of private universities and endowments, the significant proportion (around 50 percent) of tuition costs that is met by students themselves, and rigorous rating of institutional performance. These features are generally lacking in New Zealand, and current policy directions are away from competition and private provision.

Around the world, what stands out in *health* is the common problems of national health services in countries such as Britain, Canada, Ireland and New Zealand. Canada's move to a national health system was once regarded as putting it on a better footing than the United States, but few people still hold that view – some waiting lists are as long as five years and there is a constant flow of Canadians across the border for treatment in the United States. The quality of US health care is typically high, but the system is plagued with regulations that make for excessive costs. Perhaps better models for New Zealand are those of some European countries where private insurance plays a significant role and there are many private providers. In France – a country that scores well in international comparisons – one-third of the hospitals are private, in Germany half and in the Netherlands 85 percent. Sweden has been moving away from a national health service monopoly.

Finally, for *welfare* reformers, the stand-out country in recent years has been the United States, and its experience has forced a rethinking of welfare policies worldwide. The driving idea of the US reforms was that, for most people, work not welfare should be the norm – open-ended reliance on welfare was unacceptable and not in the overall interests of recipients. Intensive efforts to get beneficiaries back to work, coupled with time limits on assistance, have halved welfare rolls and improved social indicators virtually across the board. The emphasis is now shifting to the welfare role of private and charitable institutions. Family and private assistance also have a much greater role in Asian countries, which have not developed large-scale welfare states and the problems that go with them – their rate of family breakdown, for example, is a fraction of ours. Australia has a more restrictive approach to welfare than New Zealand, including on retirement income, which is subject to means testing and accounts for a lower proportion of GDP.

As we look across this range of key policies, some common lessons and practices stand out. Countries with big governments and high taxation are struggling to grow. In recent years the majority of OECD countries have reduced the government spending share of their economies and cut marginal tax rates – New Zealand is one of the few exceptions. Governments have focused on important core roles but have privatised commercial businesses and allowed more scope for private competition in formerly state-dominated areas. Free trade and open and competitive capital and labour markets are vital for growth. Labour market and welfare reforms are the key to achieving full employment and promoting many other improvements in social indicators.

The examples of best practice that I have mentioned come from countries with centre-right and centre-left governments alike. Ireland's very successful reforms were driven by the Progressive Democrats, the equivalent of the ACT Party in New Zealand, but have been embraced by all the main Irish political parties. The Reagan and Thatcher reforms in the United States and the United Kingdom were carried on by the Clinton and Blair administrations. I know of no successful country that is not still moving in the general direction of greater economic liberalisation.

I therefore conclude that if New Zealanders and New Zealand political parties are serious about wanting higher living standards and returning to the top half of the OECD rankings, we will have to bring our policies and institutions into line with those of the top performers. Indeed, we will have to do better to offset our natural disadvantages. Political parties should be challenged to align their programmes with their goals.

There are many superior policies around the world that we can use as benchmarks. New Zealanders clearly aspire to the better economic, education, health and welfare outcomes achieved by the countries I have mentioned. There is no reason why we cannot achieve similar outcomes, but major changes to adopt best practice models are required. As Reserve Bank of New Zealand governor Don Brash said at the Knowledge Wave conference, "Minor changes at the margin simply won't do the trick".

FISCAL POLICY
AND THE PUBLIC SECTOR

ARTICLE BY PHIL BARRY FOR
THE NEW ZEALAND HERALD

THE CHANGING BALANCE BETWEEN THE PUBLIC AND PRIVATE SECTORS

11 OCTOBER 2002

THE CHANGING BALANCE BETWEEN THE PUBLIC AND PRIVATE SECTORS

A notable feature of the international landscape over the last two decades has been the huge shift in control of commercial enterprises from the public to the private sector. Since 1990, close to one trillion US dollars worth of assets worldwide has been transferred to private ownership.

The World Bank has noted that "privatisation is now so widespread that it is hard to find countries not using the approach: North Korea, Cuba and perhaps Myanmar make up the shrunken universe of the resistant".

But, just because everyone else is doing it doesn't necessarily make it right. The real question is does privatisation work?

The studies almost invariably say the answer is yes.

Table 1 below summarises the results of a recent survey of the published academic studies. Twenty of the 22 studies surveyed found that businesses performed better after they had been privatised. Of the studies that compared the performance of public and private enterprises operating in the same industry, eight of the 10 concluded that the private enterprises performed better.

Table 1: Formal Studies of the Relative Performance of the Public and Private Sectors

	Private superior	No clear difference	Public superior
Effects of privatisation	20	1	1
Private versus public performance	8	2	0

Source: Megginson and Netter, *Journal of Economic Literature*, 34, 2001.

In addition, privatisation was found to increase the competitiveness of the markets the former state-owned enterprises (SOEs) operate in, because the previously state-subsidised or favoured SOEs had to succeed (or fail) on their own merits.

Recent surveys by the Organisation for Economic Cooperation and Development (OECD) and World Bank provide equally conclusive findings. In total the three surveys review over 50 different published empirical studies examining hundreds of different privatisations around the world. Few issues in economics have been subject to such exhaustive empirical investigation and provided such clear results.

The balance of evidence conclusively indicates that:

- private firms tend to be more efficient than their counterpart state-owned firms, especially in competitive industries; and
- privatisation of SOEs is likely to lead to improvements in the efficiency of the enterprises and to more open and competitive product markets, to the benefits of consumers, taxpayers and the economy as a whole.

The evidence does not suggest that private ownership is *always* more efficient. Some state enterprises can perform very well, at least for a period. Conversely, as the case of Air New Zealand highlighted, private companies can and do make mistakes. But the balance of evidence clearly demonstrates that, *on average and over time*, the private sector is likely to be more efficient than the public sector in running commercial enterprises.

But does it matter? Hasn't it all been done in New Zealand?

Not at all. As Table 2 shows, the New Zealand government still owns a vast array of commercial businesses, with assets totalling $22 billion. Local government owns even more, with investments in airports, commercial property, forestry, ports, power companies and a variety of other assets.

Table 2: Major government businesses, 2002

Enterprise	Assets $m
Accident Compensation Corporation	3,781
Air NZ	4,083
Airways Corporation of NZ Ltd	104
Crown Research Institutes	435
Genesis Power Ltd	1,105
Housing NZ Ltd	4,185
Landcorp Farming Ltd	561
Meridian Energy Ltd	2,669
Mighty River Power Ltd	1,614
New Zealand Post Ltd	630
Solid Energy NZ Ltd	131
Television NZ Ltd	520
Transpower NZ Ltd	2,280
Total	22,098

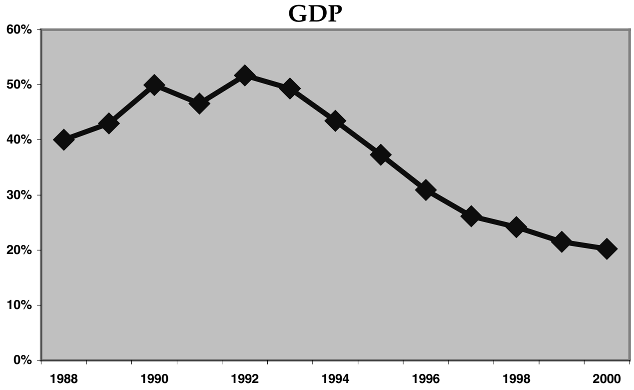
The economic studies noted above don't just indicate that there are benefits from privatisation; they indicate the gains from privatisation are large. The benefits come in the form of more efficient and profitable businesses; greater competition in markets and thus often better quality and lower cost goods and services for consumers; and greater and/or better targeted investment.

In the most comprehensive study undertaken by the World Bank, the net gains to the economy from privatisation averaged 26 percent of the firms' pre-divestiture sales. A similar gain from privatising New Zealand's central-government-owned businesses alone would boost New Zealand's gross domestic product (GDP) by around 1 percent per annum.

Many fears were raised about privatisation during the mid-1980s and 1990s. With the advantage of hindsight we can see that these fears had little substance:

- Privatisation didn't lead to fewer jobs. Over-staffed SOEs had to shed jobs but the economy as a whole gained. Total employment in the economy has grown by 22 percent since 1988.
- Privatisation has not increased the level of foreign control of New Zealand. Regardless of who owned the shares in the SOEs, the assets stayed in New Zealand, as did the jobs and the government's sovereign powers to tax and regulate. There are in fact very good reasons for allowing foreigners to participate in assets sales. The number of bidders increases, thus increasing the likely sale price for the taxpayer. In addition, foreign ownership facilitates the transfer of best practice international technology and know-how to the firm. New Zealand's small size and remoteness make it all the more important that our companies can access international capital markets.
- The Crown's financial position was strengthened, not weakened, by the asset sales. New Zealand's public sector debt declined dramatically (from over 50 percent of GDP in 1992 to under 20 percent currently), with proceeds from privatisation accounting for over half the decline.

Table 3: Net public debt as a percentage of GDP



It is sometimes claimed that despite the economic costs, public ownership helps the government achieve its social goals. But there are almost certainly better ways – such as direct assistance to low-income households – for the government to achieve its social objectives. A privileged few may benefit from state ownership. But the great majority of those on lower incomes are likely to be penalised, through the poorer, more expensive services that state enterprises typically provide and through the lower economic growth that results.

The objective evidence indicates that New Zealand, like other countries, has benefited from privatisation. To take two major examples:

- the privatisation and deregulation of Telecom New Zealand brought large benefits (estimated at $0.5 billion per annum) to consumers (from significant declines in the price of phone services, reduced waiting times for services and increased access) and to the company (from higher productivity and increased output); and
- despite concerns about the performance of Tranz Rail, the privatisation of New Zealand Rail has benefited the economy hugely (by up to $9.8 billion in total) as freight prices have fallen and taxpayers have not had to continue subsidising the state-owned rail business.

Many other former state-owned companies, like Auckland International Airport Ltd, the Bank of New Zealand, Contact Energy, Postbank, Rural Bank, State Insurance, and Works Development Services have flourished under private ownership.

However, not all privatised companies have succeeded. Air New Zealand, for example, failed spectacularly in 2001. But that doesn't mean "privatisation has failed". Sometimes private enterprises get it very wrong. That is the nature of private enterprise. But the evidence, as indicated above, clearly shows that they tend to get it wrong less often than public enterprises.

That is not to say, by any means, that all activities should be privately owned. Governments have a key role to play in owning and providing such public goods and services as courts, defence, foreign policy and police. Further, governments have a more general role of providing the legal and regulatory framework within which all enterprises operate.

In recent years, New Zealand, unlike the great majority of OECD countries, has seen the balance shift towards increasing public rather than private ownership of commercial operations. We have seen the energy industry steadily renationalised with the other energy companies selling their retail customers to state-owned entities (state-owned Genesis is now the country's biggest energy retailer), community trust-owned Vector's successful bid for United Networks (making Vector New Zealand's largest electricity lines company) and Solid Energy's buyout of Todd's share of Spring Creek (their joint coal mining venture on the West Coast). Looking ahead, it appears quite likely that some or all of the National Gas Corporation's (NGC's) power stations will end up in the public sector. In other sectors we have seen the renationalisation of accident insurance, the government's purchase of an 82 percent stake in Air New Zealand, the start-up of Kiwibank, the Auckland rail corridor buyback and the planned Wellington buyback, the pressures for the government to buyback parts of the main rail network, and the planned build up of assets in the government's New Zealand Superannuation Fund. At the same time, New Zealand (alone it would appear amongst the only OECD countries) has had a comprehensive ban on privatising SOEs.

The expansion in size and scope of the SOEs reflects the inevitable tensions that arise when the state owns commercial enterprises. The businesses naturally want to expand and be successful. But we know from all the evidence that public enterprises are typically not as efficient over time as private enterprises. And, as noted above, the differences are large enough to matter in terms of New Zealand's rate of economic growth.

The government is to be lauded for its plans to introduce legislation permitting public–private partnerships (PPPs) to finance some large roading projects. There is great scope for such PPPs to be used effectively in other areas too, like defence, justice, prisons, education and health. Perhaps eventually it will also be possible to re-open a rational, non-emotive debate on the role of the government in owning commercial enterprises.

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ROTARY CLUB OF WELLINGTON SOUTH

MEMO TO DR CULLEN: BIG GOVERNMENT HARMS GROWTH

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

WELLINGTON
25 SEPTEMBER 2002

MEMO TO DR CULLEN: BIG GOVERNMENT HARMS GROWTH

The government's top priority in this parliamentary term is to raise New Zealand's economic growth rate. Last month's Speech from the Throne stated unequivocally that the government:

> … sees its most important task as building the conditions for increasing New Zealand's long term sustainable rate of economic growth.[1]

The government has set a goal of returning New Zealand to the top half of the Organisation for Economic Cooperation and Development (OECD) income rankings. The minister of finance has said that the next couple of years will show if New Zealand is on the right track.[2]

Becoming a high income economy is a goal that deserves total support. It is the only effective solution to many of the country's economic and social problems. The government deserves credit for committing itself to a very specific goal and holding itself accountable for getting New Zealand on to a much higher growth path over the next couple of years. Its credibility will rest on whether medium-term projections for economic growth after two terms in office are consistent with its top priority goal.

A useful Treasury paper last year looked at how fast the economy would have to grow to bring New Zealand's real gross domestic product (GDP) per capita up to at least the median GDP per capita for OECD members.[3] Using reasonable assumptions it found that real GDP per capita growth of between 4.6 and 7.4 percent a year would need to be sustained for 10 years to achieve that goal. Currently the government's projections are for annual growth rates to fall away to just over 2 percent after the middle of this decade. The projections are for growth of real GDP, not per capita GDP, but because population growth is expected to fall to zero by that time the two growth rates converge.

Climbing back up the OECD ladder is not an impossible task. In the decade 1991–2001, New Zealand's real GDP grew by 3.1 percent a year on average. This was above the OECD average, more than twice the growth rate achieved by Germany and nearly three times that of Japan. Nevertheless, the Treasury calculations indicate that our projected long-term per capita growth rate of a bit over 2 percent a year would need to double, to over 4 percent on a sustained basis, to achieve the government's goal.

Doubling the economy's growth rate will obviously require major changes, but they are changes that are within our control. Economic research indicates that most of the international variation in income per capita – perhaps as much as 85 percent – can be explained by the institutions and policies that countries adopt.[4] That is good news – it means that factors such as New Zealand's size and geography do not seriously limit our potential income. But it also means that all of our institutions and policies need to

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1 Dame Silvia Cartwright, Speech from the Throne, 27 August 2002.

2 Hon Dr Michael Cullen, *Daily Post*, 25 May 2002.

3 Mawson, Peter and Scobie, Grant (2001), 'Climbing the OECD Ladder – What Does New Zealand Have to Do?', New Zealand Treasury, Wellington.

4 Richard Roll (2002), 'Quality institutions key for development', *Perspectives*, New Zealand Business Roundtable, Wellington.

be assessed in terms of their effect on growth. Every proposal before Cabinet and every Bill before parliament needs to be judged on the basis of whether it is consistent with the government's priority of growth. Those that fail the test, such as the proposal to ratify the Kyoto Protocol, must be reviewed.

There are a lot of measures that would increase New Zealand's economic growth rate, and a coherent and consistent overall programme is essential. Some, however, are more important than others. Recently, the Nobel laureate in economics Milton Friedman was asked to nominate three policy changes that would do most to increase economic growth in the United States. His priorities were free trade, a competitive education system and cuts in government spending.[4] To date, our government has moved in the opposite direction in all three areas: it has frozen tariffs, extended regulation and central control of education, and raised the long-term objective for central government spending from 30 to 35 percent of GDP. In the remainder of my remarks I want to focus on the government spending issue.

Last year the New Zealand Business Roundtable published a study, by an Australian economic consultant Winton Bates, entitled *How Much Government? The Effects of High Government Spending on Economic Performance*. The aim of the study was to survey modern research on whether high levels of public spending – and hence taxation, since most government spending has to be financed by taxation – harms economic growth. In a famous exchange of views in the 1940s, John Maynard Keynes agreed with fellow economist Colin Clark that the maximum spending and tax burden an economy could sustain was about 25 percent of GDP. This was roughly the level reached in many advanced countries by the 1960s, but its effects on economic performance took time to show up. Twenty years ago, studies on the relationship between spending and growth tended to be equivocal. Bates's review of more recent research pointed to a clear negative relationship between the size of government and growth.

A comment by professor James Gwartney, a leading researcher on economic growth, quoted in the study has received a lot of attention. Gwartney wrote:

> … New Zealand is still a big government welfare state. Government spending [central plus local government] continues at nearly 40 percent of GDP, a figure much too high 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.[5]

One critic of this statement is the minister of finance, Michael Cullen. In an election debate on 23 July 2002 he claimed it "is simply wrong". He also stated that the view that "cutting taxes leads to higher economic growth is simply not true".

Dr Cullen's rebuttal appears to be based on a memorandum from his advisor, Peter Harris. We have reviewed his analysis carefully. It is based on the following assumptions:

- that the focus is on the economic performance of OECD member countries;
- that the relevant rate of growth is that of GDP per capita; and

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[4] 'Friedman vs Laffer, An economic debate for the ages', Laffer Associates, 12 September 2002.

[5] Personal communication from James Gwartney to Winton Bates, January 2001.

- that the appropriate measure of the level of spending is the OECD's ratio of general government outlays, which includes local government, to GDP.

Mr Harris's paper acknowledges that instances of 4 percent per capita growth over an extended period of time "are not that common". Nevertheless, he identified four countries (Finland, Ireland, Korea and Luxembourg) that were "of interest" in having achieved that rate of growth for five years or more since 1985. He wrote that, of these, one (Korea) had a small government and the other three "had governments that spent in excess of the 'forty percent' level".

As Table 4 shows, Mr Harris's statement that these four countries achieved 4 percent per capita growth for five years or more is correct. However, five years is too short a period to establish "sustained" growth. Professor Gwartney's comment on this point is as follows:

> Clearly, growth during a five-year time period is often a misleading indicator of long-term sustainable growth. Finland illustrates this point. While Finland achieved 4 percent growth during the five-year period following 1994, real GDP fell by approximately 10 percent during the four years prior to 1994. Thus, Finland's strong growth during the five years following 1994 was primarily the result of recovery from a very deep recession. It did not represent long-term sustainable growth. At least a 10 year period is needed to avoid the bias introduced by cyclical factors.[6]

Moreover, the debate is in the context of lifting New Zealand's level of real GDP per capita to at least the median for OECD members. As the Treasury paper showed, New Zealand's real GDP per capita would need to grow by at least 4.6 percent a year for 10 years to achieve the government's goal. Thus, 10 years is a more relevant period to use.

When the growth objective is extended to 10 years, only three OECD countries (Ireland, Korea and Luxembourg) achieved it, as Table 4 shows. The average ratio of government spending to GDP of two of these three countries was well below 40 percent. Between 1985 and 2000, Korea's spending ratio peaked at 23.3 percent in 1999. Ireland's spending to GDP ratio was almost 51 percent in 1985. It subsequently declined to be under 40 percent in 1989 and was under that level for all but four years (1991 to 1994) up to 2000. In 2000 it was 29 percent. As Professor Gwartney has observed:

> With its entry into the EEC, Ireland liberalized its trade policies during the 1980s. It also shifted to a more stable monetary policy. After decades of expanding government, tax increases and budget deficits, the bond market virtually forced Ireland to reduce its spending in 1987. The cut was followed by a period of restraint on the growth of government. Eventually, tax rates were lowered. This combination of policies – trade openness, monetary stability, smaller government, and lower taxes – transformed Ireland into a high-growth economy during the 1990s.[7]

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6 Personal communication from James Gwartney to Roger Kerr, September 2002.

7 Personal communication from James Gwartney to Winton Bates, January 2001.

Table 4: OECD countries that achieved annual average growth in real GDP per capita of at least 4 percent a year for five, seven or 10 years consecutively

Achieved growth objective	Ireland	Korea	Luxembourg	Finland	Portugal	Spain	Mexico	Japan
Over five years in a row	1985–1990	1985–1990	1985–1990		1985–1990	1985–1990		1985–1990
	1986–1991	1986–1991	1986–1991		1986–1991	1986–1991		1986–1991
	1987–1992	1987–1992	1987–1992		1987–1992			
	1988–1993	1988–1993	1988–1993					
		1989–1994						
	1990–1995	1990–1995						
	1991–1996	1991–1996						
	1992–1997	1992–1997	1992–1997					
	1993–1998			1993–1998				
	1994–1999		1994–1999	1994–1999				
	1995–2000		1995–2000	1995–2000			1995–2000	
Over seven years in a row	1985–1992	1985–1992	1985–1992		1985–1992			
	1986–1993	1986–1993	1986–1993		1986–1993			
	1987–1994	1987–1994	1987–1994					
	1988–1995	1988–1995	1988–1995					
	1989–1996	1989–1996						
	1990–1997	1990–1997	1990–1997					
	1991–1998		1991–1998					
	1992–1999	1992–1999	1992–1999					
	1993–2000	1993–2000	1993–2000	1993–2000				
Over 10 years in a row	1985–1995	1985–1995	1985–1995					
	1986–1996	1986–1996	1986–1996					
	1987–1997	1987–1997	1987–1997					
	1988–1998	1988–1998	1988–1998					
	1989–1999	1989–1999						
	1990–2000	1990–2000	1990–2000					

That leaves Luxembourg. It appears to be a marginal case. According to the OECD data, its spending ratio was above 40 percent between 1990 and 1997 (peaking at 44 percent in 1992 and 1993), 40 percent in 1998 and 1999 and 39 percent in 2000. The OECD data also show Luxembourg sustaining just over 4 percent growth for 10 years in a row. However, as Professor Gwartney has commented:

> While Luxembourg may have achieved real growth of 4 percent during the 1990s, how relevant is it to the issue of whether high levels of government expenditures generally retard growth? Luxembourg has a population of 439,000 and an area of 3,000 square kilometres. It is more comparable to a modest sized city. For various reasons, small geographic areas often experience rapid growth …[1]

There seem to be some question marks over the OECD data for Luxembourg for both expenditure and GDP, and we want to look further into them. But even if we accept Luxembourg as a marginal case, the upshot of the debate is that the experience of 25 of the 26 OECD countries suggests public spending at New Zealand's level is inconsistent with the government's goals for sustained growth. Dr Cullen has also acknowledged that New Zealand's policies need to be better than other countries' to offset its natural disadvantages if we are to match their performance. It would therefore be reckless to base policy on a marginal case: as Nobel laureate George Stigler has noted:

> … we must base public policy not upon signal triumphs or scandalous failures but upon the regular, average performance of the policy.

Let me now turn to Dr Cullen's claim that there is no evidence that lower government spending and taxing is likely to lead to higher growth.

Economic analysis suggests that up to some point government spending on public goods and services such as defence, law and order, and public health, and on appropriate regulation, contributes to growth. However, as the ratio of government spending to GDP increases beyond the optimum level, additional spending depresses growth for the following reasons:

- As government grows relative to the market sector, the returns to government activity diminish. The larger the government, the greater is its involvement in activities it does poorly.
- More government means higher taxes. As taxes take more earnings from citizens, the incentive to invest, develop resources and engage in productive activities declines.
- Compared with the market sector, government is less innovative and less responsive to change. Growth is a discovery process. In the market sector, entrepreneurs have strong incentives to discover new and improved technologies, introduce better methods of doing things, and exploit opportunities that were previously overlooked. Also, they are in a position to act quickly as new opportunities arise. In government, the nature of the political process lengthens the time required to modify bad choices (such as ending ineffective programmes) and adjust to changing circumstances. As the size of government expands, the sphere of innovative behaviour shrinks.

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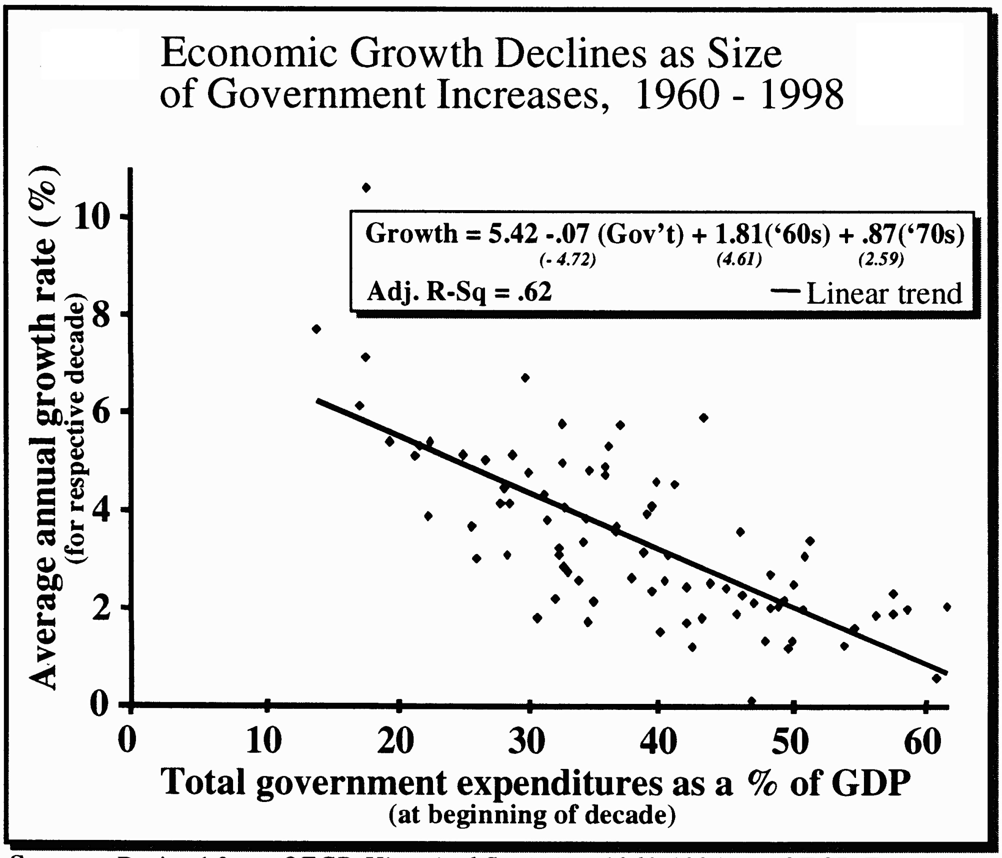
[1] Personal communication from James Gwartney to Roger Kerr, September 2002.

- As government grows, it becomes more heavily involved in redistributing income and in regulatory activism. Redistribution blunts incentives for wealth creation. It also induces people to spend more time seeking favours from the government and less time producing goods and services for consumers.

In contrast to Dr Cullen's claim, the *Report of the Joint Economic Committee, Congress of the United States, on the 1999 Economic Report of the President* contains an empirical analysis that showed that the rate of economic growth declines as government spending increases. The relationship is plotted in the diagram below.



Source: Derived from *OECD Historical Statistics: 1960-1994* and *OECD Economic Outlook*, June 1999. This analysis is based upon 84 observations (21 OECD countries for which data were available times 4 decades).

The study found that a 10 percentage point increase in the size of government as a share of GDP reduces the long-term annual growth rate of real GDP by 0.7 percent.[2] On this basis, the government's decision to increase the long-term objective for government spending from 30 to 35 percent of GDP knocked perhaps one-third of a percentage point off New Zealand's potential growth rate. These findings are consistent with others reported by Winton Bates.

More recent evidence comes from a comparison of the economic performance of US states. A study found that during the 1990s the 10 states with the highest tax burden grew at half the rate of the 10 states with the lowest taxes. Personal income grew by 40

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2 *Report of the Joint Economic Committee, Congress of the United States, on the 1999 Economic Report of the President*, US Government Printing Office, Washington, 1999.

percent in the low-tax states but only by 25 percent in the high-tax states. Job growth was 28 percent in the low-tax states but only 13 percent in the high-tax states.[3]

What's more, I know of no study that shows the opposite relationship, namely that higher taxes, beyond prudent funding of public goods, leads to faster growth.

It is therefore extraordinary that Dr Cullen remains in denial in the face of such evidence. Following the spending reductions of the early 1990s, the New Zealand economy grew by nearly 4 percent a year in the five years to 1996 (the more consistent overall policy framework, and possibly cyclical factors, also played a part in this expansion). Subsequent increases in spending dampened the growth rate. On the tax side, there is abundant evidence that lower taxes encourage work, saving and investment, and increase economic growth. A Treasury study advised that "The case for reducing taxes remains strong because … even small increases in economic growth will lead to substantial improvements in living standards in the long term".[4] Mary Harney, Ireland's deputy prime minister and leader of the free-market Progressive Democrats, has stated that "low taxes are the *central* reason for Ireland's economic success" (emphasis added).[5]

Dr Cullen has long been an admirer of Germany – he has commended what he calls the 'Rhenish model'. Germany should be an object lesson for New Zealand, but for the opposite reasons. Germany is one of Europe's biggest welfare states, and its average annual growth rate in the decade to 2001 was 1.5 percent. In the 2002 World Competitiveness Report ratings, Germany ranked forty-seventh out of 49 major countries for flexibility and adaptability. Germany's deep-seated malaise, including a bottom rung in the European Union for unemployment, goes well beyond the problems in the East. The former free-market miracle has long since lost its way; its average income level is now below Australia and only just in the top half of the OECD, and its ranking is likely to fall further.

Arguments such as I have made for shrinking the size of government are often met by the response: 'What programmes do you propose to cut?'. This has it exactly backwards. No less an impeccable source than President John F Kennedy argued correctly when he said:

> It is a paradoxical truth that tax rates are too high today and tax revenues are too low – and the soundest way to raise revenues in the long run is to cut rates now.

Ireland's experience in reducing its spending ratio from over 50 percent of GDP in the 1980s to around 30 percent today bears this out – its rapid economic growth has allowed large increases in government spending on services such as health and education. Winton Bates's study pointed out that if New Zealand's real GDP were to grow by 3 percent a year and spending were held constant in real terms – not cut at all – the spending ratio would fall by 5 percentage points over five years. In practice, there is ample scope to achieve expenditure reductions in New Zealand by cutting wasteful and badly targeted programmes.

The key points I would like to leave you with are therefore as follows:

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3 'States of Prosperity (or Not)', *Wall Street Journal Online*, 16 July 2002.

4 Gavin Lockwood (1998), 'The relationship between taxes and growth', Working Paper, The Treasury, Wellington.

5 Mary Harney, 'Harmonisation of EU taxes is out', *The Irish Times*, 24 February 2002.

- achieving the government's goals of getting New Zealand into the top half of the OECD income rankings requires sustained per capita economic growth in excess of 4 percent a year;
- OECD experience indicates that Dr Cullen's apparent belief that New Zealand can achieve a 4 percent per capita growth rate with total government spending (that is, including local government) equal to 40 percent of the economy is not credible;
- Dr Cullen's claim that there is no evidence that high government spending and taxation depress growth is also wrong;
- a lower ratio of government spending to GDP is not a sufficient condition for meeting the government's growth target – many other policy changes are needed – but it is a necessary one.

More generally, the historical picture is very clear. The rich countries in the world today got rich with relatively small government. Prior to the first World War, government spending in the United States, Sweden and Japan was about 10 percent of GDP or less, and the average for advanced countries was about 13 percent. Even in the so-called 'golden age' of the 1950s and 1960s, public expenditure in most countries (including New Zealand) was only in the 20–30 percent range. Big government in the developed world is really a post-1960s phenomenon. It was associated with a much poorer economic performance in the 1970s and 1980s. The exceptions during this period were the fast-growing Asian countries, which all had small governments. From the 1980s, most OECD countries have moved to policies involving greater economic freedom, including falls in their public expenditure to GDP ratios since the early 1990s. The main exception is Japan, where government spending rose from under 20 percent of GDP in 1970 to nearly 40 percent today, and which is in deep economic trouble.

The empirical record shows that it is extraordinarily unlikely that New Zealand can achieve the kind of growth rate targeted by the government with total government spending equal to 40 percent of the economy. My conclusion is that without a lower objective for the central government spending ratio, and tighter disciplines on local government, its growth strategy is simply not credible. Many other moves towards greater economic freedom would be needed as well.

ARTICLE BY ROGER KERR FOR
THE NEW ZEALAND HERALD

TAXES, GROWTH AND PUBLIC SERVICES

2 APRIL 2002

TAXES, GROWTH AND PUBLIC SERVICES

When searching for sound public policies, we should not rely on hunches or suppositions. We should not look at one feature of a country's policies in isolation from others and draw sharp conclusions about its effects. We need a disciplined process of analysis.

On tax, we are fortunate to have such a process with the recent McLeod Tax Review. The government put together a group of competent experts with varying perspectives who reached remarkably common ground.

The McLeod review was not charged with advising on government spending, which is where any appraisal of fiscal policy needs to start. Government spending is the best measure of the overall tax burden, because most spending sooner or later has to be funded from taxation. Thus, broadly speaking, a country with a 40 percent ratio of (central plus other) government spending to gross domestic product (GDP) – like New Zealand – has an average tax rate of 40 percent. The average taxpayer spends two days in a five-day week working for the government sector.

No country has achieved sustained per capita economic growth of 4 percent or more with government spending equal to 40 percent of the economy. This suggests it can't be done. So for New Zealand, the first requirement for the higher growth rates targeted by politicians and the benefits that go with them – like higher wages, wider choices, more resources for health, education and the environment – is smaller government. Ireland's economic success has been associated with a decline in its government spending ratio from over 50 percent of GDP in the 1980s to around 30 percent today. The key to this achievement has been keeping the growth rate of spending within the growth rate of the economy and following other pro-growth policies.

To finance a given level of government spending at minimum cost to growth, taxes should be as broad-based and uniform as possible. The McLeod review advocated a lower and flatter tax structure for New Zealand. This conclusion is widely supported by tax professionals.

The report was implicitly critical of the government's decision to raise the top income tax rate to 39 percent. The higher tax rates on marginal income generally do the most damage to economic growth – they blunt incentives to work, save, invest and take risks. Thus it costs more than a dollar to raise a dollar of tax – perhaps as much as $1.50 as the economy's output is affected in the process. The increase also made the tax system much more complex. The McLeod report pointed out that most income redistribution occurs through government spending – progressive taxation is not needed to achieve that goal.

The government justified the tax increase on the grounds that it wanted to increase spending on social services but it did not demonstrate that the additional spending represented value for money, given the costs of raising the extra tax. Moreover, the largest share of new spending went on superannuation, and the problem with health and education is not so much inadequate funding as bad systems. Essentially, health (other than primary care) and education in New Zealand are state-dominated, with all the problems associated with monopolies – dissatisfied customers, queues (waiting lists and zoning), one-size-fits-all services and endemic frustration for capable people working in them. We saw the dramatic benefits of choice and competition for all concerned when the accident compensation monopoly was briefly removed.

Other countries, including Australia, allow a much greater role for private provision and funding of health and education. Most schools in Ireland are private but are funded on a similar basis to state schools. Sweden has given the private sector a bigger role in health provision with strong support from health unions, which have seen gains for their members. The British Labour government is trying to implement similar changes.

Some point to European countries such as Finland that have more progressive tax systems and enjoyed relative economic success. But Finland is no stand-out performer: it averaged 3.2 percent annual economic growth in the 10 years to 2001 compared with New Zealand's 3.1 percent, according to International Monetary Fund (IMF) figures, and its unemployment rate is still around 10 percent.

Moreover, there is no more reason to attribute Finland's reasonable record to its progressive tax any more than to its farm subsidies: economic analysis would suggest that both have harmed its economy. More important features of Finland's experience are the reduction in its government spending ratio from 59 percent of GDP in 1993 to 45 percent today and other moves to greater economic freedom.

It is true that people in higher income brackets would benefit from reversing the increase in the top rate – this is inevitable because they pay the most tax – but they would not be the only ones to benefit. For a start, the government might actually collect more revenue. In 1983, when the top tax rate was 66 percent the top 5 percent of taxpayers paid 23 percent of all income tax. Last year when the top rate was 39 percent the top 5 percent paid 34 percent of total income tax, according to Treasury figures. The LEK Consulting report to the government argued that a lower top tax rate would help retain and attract talent. Broad benefits accrue from the spur to growth provided by lower taxes. New Zealand can only sustain first world health and education services with a first world economy. Because lower taxes mean stronger growth, they mean more resources for health and education over time, not less.

The Bush administration is just the latest in a major country to move to a lower, flatter tax structure. As a country with some natural disadvantages, New Zealand must aim to 'stand out from the crowd' by having tax policies that are more conducive to growth than other countries if we are to match their achievements. The McLeod report should be the reference point for all political parties in drawing up tax policies.

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE BUDGET POLICY STATEMENT 2002

JANUARY 2002

2002 BUDGET POLICY STATEMENT

Executive Summary

- From the viewpoint of New Zealanders' living standards, the most important commitment the government has made is to restore New Zealand to the top half of the Organisation for Economic Cooperation and Development (OECD) income rankings. It has also stated a goal of achieving a 3 percent unemployment rate. The government has set store on delivering on its commitments.
- Economic strategies take time to produce results. The path of the economy in this parliamentary term will have been largely determined by previous policy settings and external and cyclical events. Projections for the next three years will be reflecting assessments of the effects of the government's policies.
- In the 2001 budget the government acknowledged that New Zealand's growth outlook is unsatisfactory. To achieve within 10 years the goal of reaching the top half of the OECD income rankings, a sustained annual per capita growth rate of between 4.6 and 7.4 percent is required.
- The Budget Policy Statement 2002 (BPS) projections indicate that the government's policies are not moving New Zealand closer to this goal. In section 2 of this submission we note that the projections for economic growth envisage an underlying growth rate of gross domestic product (GDP) per capita of only 1.5 percent per annum. While we believe that this could be optimistic, we concur with Treasury's implicit view that the government's policies are incapable of achieving its stated goal. The Treasury's projections for unemployment also indicate that the government is not on track to achieving its goal of 3 percent unemployment.
- The government's failure to address the gap between its stated objectives for economic growth and unemployment and the reality of these forecasts creates problems of credibility. In section 3 we find that the BPS lacks a coherent strategy for closing this gap.
- In section 4 we make the point that conformity with the principles of the Fiscal Responsibility Act 1994 in funding government spending is a necessary but not sufficient condition for good fiscal stewardship. No fiscal policy is sound if the spending itself is wasteful or poorly targeted. We are critical of the government's novel premise that a sound fiscal policy involves increasing spending more or less in line with revenue growth simply on the grounds that there is money available to spend. It is impossible for the government to establish that spending provisions are justifiable when it does not know what they will be used for. The government appears to be only paying lip service to its declared aim of getting better value for money in government spending.
- We also argue that the government should conform with the requirement in section 6(2)(a) of the Fiscal Responsibility Act 1994 to specify its long-term objectives for total operating expenses, rather than for an aggregate that lacks any economic or accounting rationale.
- In section 5 we commend the government for resisting pressures to increase government spending even further for counter-cyclical reasons, but criticise its rationale for this decision.

- In section 6 we oppose the government's intention not to publish an objective for net debt in future BPSs.
- In section 7 we reiterate our opposition to the New Zealand Superannuation Fund and associated expenditure-increasing measures.
- In section 8 we stress the importance for any sound growth strategy of lower tax rates and urge the government to give favourable consideration to key recommendations of the McLeod Tax Review.
- In section 9 we revisit the importance for economic growth of lowering regulatory burdens.
- Section 10 contains a number of recommendations that would constitute a more credible strategy for economic growth if incorporated in this year's budget. While these would involve changes to government policy that might be difficult to contemplate, the absence of a credible strategy and the likelihood of continuing mediocre economic performance is no less unpalatable a prospect for the community.

1 Introduction

1.1 This submission on the Budget Policy Statement 2002 (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 The 2002 budget will complete the government's fiscal programme for its current term of office. By foreshadowing its major features, the BPS provides an opportunity to assess the likely contribution of this programme to the government's major economic objectives.

1.3 We have made submissions on 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 good communication between the government and the wider community, particularly the business and investment community. We believe that the select committee process should be used to facilitate constructive dialogue on the government's fiscal plans.

1.4 The following sections of this submission focus on the strategy for economic growth that is implicit in the BPS. They end with some recommendations.

2 Inadequate prospects for economic growth

2.1 In the 2001 budget the minister of finance stated that:

> We need to set ourselves a goal of being back in the top half of the developed world in terms of per capita GDP – a position we have not occupied since 1970. Even if we set the target for achieving that goal well into the future it still means lifting our present sustainable capacity from about 3% a year to 4% a year or more.

2.2 A Treasury paper has estimated that per capita real gross domestic product (GDP) would need to grow at 4.6–7.4 percent per annum for 10 years in order to get New Zealand back into this position.[1]

2.3 Such aspirations are not remotely credible under current policies. The per capita growth rate was only 1.8 percent per annum between 1991 and 2001. The forecasts for economic growth contained in the December Economic and Fiscal Update 2001 (DEFU) project trend per capita growth of only 1.5 percent per annum.[2] This is unchanged from the trend assumed in Annex 3 of the 24 May 2001 Fiscal Strategy Report.[3] In conjunction with demographic projections by Statistics New Zealand, this translates into real GDP growth of around 2.75 percent by the end of the current forecasting period (2006) falling to 2.2 percent up to 2011 and to 1.6 percent thereafter.[4]

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[1] Peter Mawson and Grant Scobie (2001), 'Climbing the OECD Ladder: What Does New Zealand Have to Do?', New Zealand Treasury, Wellington.

[2] December Economic Fiscal Update, pp 42–43.

[3] Fiscal Strategy Report, Budget 2001, p 33.

[4] December Economic Fiscal Update, p 42; Fiscal Strategy Report, p 33.

2.4 Moreover, there is no indication in the Treasury's forecasts of any recent lift in New Zealand's growth prospects. Prior to the last election, the Treasury forecast (in the 1999 Pre-Election Update) that growth four years ahead (2003) would fall to 2.9 percent.[5]

2.5 In our view, the Treasury's assessments are more likely to err in being too optimistic. It is more than plausible that the policies followed by successive governments since 1993 have been reducing the achievable long-term growth rate. We recently suggested that New Zealand's trend growth may now be down to around 2.5 percent per annum.[6] Even if the Treasury's assumed per capita trend growth of 1.5 percent per annum could be achieved, the average living standards of New Zealanders would not reach the top half of those in the OECD in the foreseeable future.[7]

3 The strategy in the BPS for economic growth

3.1 The 2001 budget did not contain a recognisable growth strategy.[8] The BPS does not outline one for the coming budget.

3.2 The BPS asserts that the government's "priorities for this year have a strong development component. This involves further developing the asset base, improving New Zealanders' living standards, developing our human capital and providing certainty to improve planning".[9] It then proposes large increases in operational spending on state health and education and further increases in industry development spending. It also proposes to bring forward capital spending to reflect "key capital pressures" in the social sector (hospitals and schools), prisons, transport, re-equipping the Defence Force and recapitalising Air New Zealand.[10]

3.3 Increases in government spending of this nature do not constitute a growth strategy. At current levels of spending, the deadweight costs of each additional dollar spent out of taxes effectively reduce national income by something in the region of 50 cents on average, even if it produces a dollar of value.[11] In fact there are good reasons for believing that the institutional

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5 This was not an aberration, because the Treasury has been forecasting in Budget Policy Statements for many years now that economic growth would slow to below 3 percent per annum by the end of each four-yearly forecasting period. The Treasury's current forecast for 2003 is 1.9 percent, but this reduction clearly reflects the Treasury's assessment of the effects of the current international slowdown rather than its assessment of New Zealand's longer-term growth prospects.

6 Speech by Roger Kerr, 'Getting up the OECD Rankings', New Zealand Business Roundtable, 26 November 2001.

7 According to the latest international comparisons from Statistics New Zealand, New Zealand's GDP per capita would have had to be 55 percent higher in 2000 (that is, at US$20,000 instead of US$13,000) in order to match the Australian level.

8 See speech by Roger Kerr, 'Agenda 2002: An Election with Vision', New Zealand Business Roundtable, 28 January 2002, p 3.

9 Budget Policy Statement, p 5.

10 This section of the BPS also stresses the importance of keeping growth in spending below nominal GDP growth and actively reviewing value for money in government spending. We discuss these issues in the next section.

11 For details on this estimate see Winton Bates (2001), *How Much Government?: The Effects of High Government Spending on Economic Performance*, New Zealand Business Roundtable, Wellington.

arrangements in health, education and social welfare are so bad that each dollar spent will return much less than a dollar in value. It is difficult to describe the evident determination of any government to pour good money into systems that are guaranteed to waste it as anything other than irresponsible. The problems in health and education in New Zealand mirror those in centrally directed and planned systems elsewhere. There is a vast amount of evidence that such systems do not work.

3.4 Economists have long recognised that competition, private ownership and decentralised decision-making are the key to forcing providers to serve the interests of consumers. *The Economist* recently highlighted the folly of spending more money on health services in the United Kingdom without reforming them. It called the proposals for increased spending a "terrible mistake, both for voters and for the government".[12] Second, according to highly respected Harvard University economist Martin Feldstein, many researchers have concluded that competition and decentralisation are essential for reducing schooling failures.[13]

3.5 Far from representing a coherent strategy, the increases in spending in health and education look like a short-term political response to crises of a structural nature. It is even more obvious that the spending on Air New Zealand is a response to exigencies related to government regulation in Australia and New Zealand. This spending was entirely reactive.

3.6 As the minister of finance correctly observed in his 2001 budget, lifting a country's underlying growth rate is no easy matter. In our submission on the 2001 BPS we summarised the essential elements of a sound growth strategy. If New Zealand's economic performance is to improve markedly, far-reaching and fundamental changes are necessary. In our view, these include extensive privatisation, reduced spending and tax rates, less government regulation of business and of interactions between private individuals, and a much improved performance by the state in relation to core government activities.

3.7 The government's failure to implement a growth strategy that is consistent with its own growth targets is disappointing.[14] As we noted in last year's BPS submission, there can be no meaningful dialogue about what might constitute a more successful strategy if the government continues to take an ideologically rigid position on key issues. These include the roles for competition, the price mechanism, the private sector, privatisation, tax rates and the level of government spending.

Continued
Note in this context that a recent study for the Joint Economic Committee of the United States Congress assessed the cost in that country to be at least 40 cents in the dollar. Government spending accounts for a much lower percentage of national income in the United States.

12 'British Fiscal Policy: Cash is no Cure', *The Economist*, 1 December 2001, p 15, and 'National Health Service: Walking Wounded', *The Economist*, 24 November 2001, pp 57–58.

13 Martin Feldstein (1999), 'Reducing Poverty, Not Inequality', *The Public Interest*, No 137, Fall, pp 33–41.

14 The Treasury's projections for unemployment demonstrate that the government also appears to be content only to pay lip service to its professed target of reducing the unemployment rate to 3 percent. See DEFU p 30.

4 The BPS's concept of sound fiscal management and good fiscal stewardship

4.1 The quality of fiscal policy matters for prosperity.[15] Crown operational spending is to be of the order of 33 percent of GDP (although imminent accounting changes are set to lift this by around 5 percent of GDP).[16] The Crown is a major owner and purchaser of assets.[17] (Successive governments have also played a major regulatory role, the effects of which have often been to impede freedom of contract and to remove private property rights without compensation.) When governments assume such a large economic role the quality of their policies strongly influences national economic performance.

4.2 On page 1 the BPS refers to the achievement of policy commitments, operating surpluses and the need for consistency with debt objectives. On page 2 it presents "good fiscal stewardship" as a matter of keeping spending increases below projected increases in GDP and running surpluses that help achieve independently derived debt targets. On page 8 the BPS returns to this theme. It asserts that the government is working from "sound fiscal management foundations". It goes on to state that:

> The underlying premise remains unchanged – the combined increase in capital and operating spending has to be in line with nominal GDP growth such that debt as a percentage of GDP is stable and trends towards our objective over the longer-term.

4.3 Contrary to the opening remark in this statement, to the best of our knowledge this is the first time such a premise has been proposed in a BPS. Nor are we aware of any basis in the Fiscal Responsibility Act 1994 for proposing that debt should be stable as a percentage of GDP. The principles enumerated in the Fiscal Responsibility Act refer only to the desirability of predictability about the level and stability of *tax rates* for future years.

4.4 We do not know of any basis in public finance theory for suggesting that public debt should be stable as a percentage of GDP. To the contrary, if government spending plans are soundly based and tax rates are to be reasonably stable through time, it follows that operating balances and debt will fluctuate in response to unevenness in spending plans and revenues. To propose that debt ratios be stable is to propose that spending plans be adjusted regardless of value-for-money considerations. This makes no economic sense.

4.5 Instead, the government should put value for money first in determining expenditure plans, taking the deadweight costs of taxes and the importance of a high level of economic freedom into account. Spending plans determine the

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15 See, for example, Bates, *op cit*.

16 See DEFU p 46 for the lower figure. The 5 percentage points estimate is based on the table provided on p 71. This table provides indicative figures summarising the full effects on measured Crown spending of the pending change in the 2002 budget to generally accepted accounting principles (GAAP) rules requiring the adoption of line-by-line consolidation. The increase occurs despite an associated reduction in core Crown expenditure of around $1 billion from the pending exclusion of goods and services tax (GST) (see DEFU p 15).

17 On p 23 the DEFU explains the extent of the government's borrowing programme by observing that investment outlays of $23.6 billion (during the next five years) exceed cash surpluses by $10.6 billion. Such outlays represent 3.8 percent of forecast GDP during the period.

average revenue requirement through time and therefore, in conjunction with projected income growth, average tax rates. Stability in tax rates consistent with this average funding requirement implies instability in the operating balance and in debt. Capital spending is intrinsically lumpy and unevenness in this spending will also contribute to changes in debt as a percentage of GDP. The requirement in the Fiscal Responsibility Act for debt to be at prudent levels in no way implies that it should be stable through time. The debt tail should not be permitted to wag the spending dog.

4.6 More importantly, the premise that government spending should be increased in line with GDP is devoid of value-for-money considerations. For many years successive governments have provided for major spending increases without knowing how they propose to spend the money. When they don't know what it is to be spent on they do not know that it represents better value for money than lower taxation.

4.7 In contrast, a responsible fiscal policy would assess the relative merits of spending increases or tax cuts on a principled basis. It would acknowledge the deadweight cost of taxes and the undesired perverse incentive effects of much government spending. It would develop a principled public good and equity basis for determining government spending priorities. Ensuring the provision of public goods (not goods and services that can be supplied privately) and of a sound safety net (including underwriting access to health services and education) should be the government's key roles.

4.8 The government cannot credibly claim that all existing spending reflects value for money. In our view there is every reason to agree with the statement in the BPS 2001 to the effect that much current spending is wasteful.[18] We are assailed almost daily by newspaper reports of incompetence, waste and fraud in government spending. Governments typically lament the gap between the outputs of spending programmes and the outcomes that they seek. Departmental post-election briefing documents routinely gloss over the absence of any adequate proof that spending is effective by stating that "more research needs to be done" in evaluating its impact.

4.9 We have seen no evidence of material savings following the statement in the BPS 2001 that the government's "initiatives in 2001 will also focus on improving the effectiveness of existing policy interventions". In response to a question at the 2001 budget lock-up, the minister of finance acknowledged that little had been achieved to that point but suggested there were savings to be made in some areas, notably health. It is difficult to be optimistic about the statement in the latest BPS that "we are actively reviewing the value for money the Government receives from its expenditures and investments, and are continually looking at ways of reprioritising expenditure to best match the Government's social and economic objectives".[19] There is no tangible evidence of progress. A concern here is that the government's objectives in an election year may reflect party political concerns rather than the national interest.

4.10 In short, the BPS does not appear to recognise that a responsible fiscal strategy requires value for money in spending as well as prudent funding of that

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18 See BPS 2001, p 7, last paragraph.

19 Budget Policy Statement, *op cit*, p 7.

spending through taxes and debt. Compliance with the principles of the Fiscal Responsibility Act 1994 only addresses the latter aspect. If much spending is wasteful, it is obviously better if expenses grow at less than the rate of growth in GDP rather than at the same, or a higher rate.

4.11 The minister of finance claims credit for reducing government spending as a percentage of GDP since taking office. The government's degree of fiscal discipline has been important for business and financial market confidence. However, projected spending for 2002/03 is now more than $1 billion higher than was projected by the Treasury under the previous government's policies. With evident expenditure pressures we see risks that the government will be unable to keep within the current (increased) limits it has set for itself, and of future tax increases. If the government is serious about reducing government spending as a percentage of GDP it is hard to see why it increased the long-term target in the BPS 2000 for operating expenses from below 30 to around 35 percent. In the light of its more recent statements it should reverse that decision.

4.12 The BPS forecasts that in 2004/05 operating expenses will be 32.4 percent of GDP and that capital transfers to the New Zealand Superannuation Fund will be around 1.6 percent.[20] The government proposes to hold operating expenses well below 35 percent of GDP while capital contributions to the Fund are positive and to raise them above 35 percent when they are negative so that the total is held at around 35 percent. However, there is no economic case for varying operating expenses in a manner that so obviously ignores value-for-money considerations. Nor is there any obvious accounting justification for combining operating expenses with the capital contribution. Moreover, section 6(2)(a) of the Fiscal Responsibility Act 1994 requires the government to specify its long-term objectives for total operating expenses in each BPS, not some composite aggregate. In our view the government would communicate its intentions more clearly if it stuck to a target for operating expenses alone. On the basis of the 2004/05 projection, the target should be below 33 percent of GDP.

5 Counter-cyclical fiscal policy considerations

5.1 On page 3, the BPS commendably resists the argument that the government should increase its spending further for counter-cyclical reasons. Unfortunately, it does so on the grounds that "our assessment of the fiscal stance is that the Government is moderately supporting economic growth over 2001/02. This largely reflects higher capital spending in 2001/02, including equity injections into hospitals and increases in student loans".

5.2 This rationale assumes that increased government spending can support economic growth, even if it is on unprofitable projects. Economists have long since discarded such hubristic and profligate Keynesian notions.[21] At current levels of spending, there are sound grounds for believing that fiscal

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20 Budget Policy Statement, *op cit*, p 13.

21 See for example, Martin Feldstein (1981), 'The Retreat from Keynesian Economics', *The Public Interest*, No 64, Summer; Robert Skidelsky (1997), 'Bring Back Keynes', *Prospect*, May; Robert Barro (1992), 'Keynes is Still Dead', *Wall Street Journal*, October, pp 30–32; and 'Unbalanced Keynesians', *The Economist*, 11–17 September 1999, 20th Century Survey section, p 15.

contractions can be expansionary. For example, a recent study of fiscal contractions in 18 OECD countries between 1960 and 1996 found that spending cuts in particular can have large expansionary effects.[22]

5.3 Once again, we stress the importance of judging the soundness of each and every item of government expenditure on its own merits in evaluating the contribution of government spending as a whole to the welfare of the community.

6 Gross and net debt targets

6.1 On page 12 in Annex II, the BPS states that the government has dropped net debt as a fiscal objective, in good part because "two objectives can be confusing, because it is not clear which is binding". While the text supplements this reason with the comment that the trend in gross and net debt is similar, it is clear from their nature that this will not necessarily always be so. The difference between the two, "financial assets", includes such potentially large and volatile items as the value of the New Zealand Superannuation Fund, advances to state-owned enterprises and student loans.

6.2 We question the rationale for this decision and therefore the decision itself. In our view a coherent budget strategy will involve internally consistent forecasts for the major aggregates such as expenses, revenues, operating deficits, assets and liabilities, including gross and net debt and the government's borrowing programme. When likely outcomes differ from plan, it is up to the government to determine its priorities in setting new targets or objectives. We know of no economic basis for presuming that any adjustments should seek to preserve an earlier gross debt target rather than an earlier net debt target, or either target. Nor does the Fiscal Responsibility Act 1994 appear to imply any such requirement.

6.3 We are not aware of the basis for the concern that the presence of both objectives is causing confusion. If it is occurring amongst financial market professionals it should presumably be possible to explain to them that these objectives are not set independently and so are not in conflict. They simply represent different components of a coherent overall plan.

6.4 Given the potential for significant differences between the two series, in our view the elimination of one of these objectives would represent a material reduction in the quality of information disclosure in future BPSs.

7 New Zealand Superannuation Fund

7.1 As we stated in our submission last year on the New Zealand Superannuation Bill, the government's pre-funding proposal is largely an accounting exercise with no direct economic impact on the retirement problem.[23] By creating the

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22 Alberto Alesina, Roberto Perotti, Silvia Ardagna and Fabio Schiantarelli (1999), *Fiscal Policy, Profits and Investment*, National Bureau of Economic Research Working Paper 2707. See also Tony Makin (1998), 'When Contractionary Fiscal Policy is Expansionary', *Agenda*, Vol 5, No 4, pp 419–426, and International Monetary Fund (1996), *World Economic Outlook*, Washington, DC, May.

23 *Submission on the New Zealand Superannuation Bill* (2001), New Zealand Business Roundtable, Wellington, February.

false impression that it alleviates future funding burdens it could discourage private savings. Other policies, such as the attempt to entrench the age of eligibility and the level of payment of New Zealand Superannuation, and the lift in the government expenditure to GDP target to 35 percent, will increase future funding difficulties. The Fund constrains the scope for tax reductions that would spur growth and enlarge the economic cake. The availability of an adequate level of real goods and services is ultimately the only safeguard for retirement living standards. We consider that the Fund should be wound up and the proceeds used to repay debt.

8 Taxation and the McLeod Tax Review

8.1 In our view no strategy for materially lifting economic growth prospects will be credible unless it envisages significant reductions in marginal tax rates in conjunction with spending reductions. The tax scale needs to be flattened as the McLeod report recommended. The top personal rate of tax should be reduced and aligned with the corporate tax rate. The medium-term goal should be to reduce all income tax rates to a maximum of 25 percent.[24] We concur with the views contained in the McLeod report about the basic soundness of the New Zealand tax system, the merits of a broad-based, low-rate structure, and the weak case for some novel forms of taxation that have been proposed. These include the idea of a dedicated health tax.

8.2 There have been suggestions of an increase in the excise tax on petrol. The McLeod committee, correctly in our view, recommended that, in general, excise taxes, including on motor spirits, should be abolished. Problems of road congestion have much to do with misplaced spending priorities, expensive delays to new projects caused by government regulation, the lack of progress on introducing congestion pricing, the failure of successive governments to increase the role of the private sector, and uneconomic commitments such as the Britomart project and ill-justified subsidies for selected forms of public transport. Meanwhile, road users have been making a large contribution to general government revenue. Instead of taxing motorists more heavily these longstanding problems should be addressed.

9 Regulatory burdens

9.1 Enhanced rates of economic growth cannot be achieved if governments deter investment through an unfavourable regulatory environment. In recent years the increased regulation of business has been relentless, particularly in the labour market, safety, environmental, utilities and securities market areas. This trend is continuing and there have been few initiatives to reduce regulatory costs. The government's business compliance cost review has yielded meagre results. Ratification of the Kyoto Protocol in advance of major trading partners and in the absence of sound analysis would impose further costs on New Zealand businesses.

9.2 In our view, one problem here is that successive governments have failed to require departments proposing regulations to support them with professionally competent regulatory impact statements. Competent analysis is

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24 For our detailed reasons, see *Submission on the Tax Review 2001 Issues Paper* (2001), New Zealand Business Roundtable, Wellington.

a necessary first step to improving regulatory policies. Consideration should also be given to the concept of a regulatory responsibility act.[25]

10 Recommendations

10.1 New Zealand's economic outlook is acknowledged by the government to be inadequate. To improve the economy's growth prospects we recommend that it give serious consideration in this year's budget to:

- restoring the goal of reducing expenses to below 30 percent of GDP;
- moving towards more uniform rates of income tax at a lower level, with a maximum of 25 percent being a medium-term goal;
- aligning the top personal rate with the corporate tax rate;
- undertaking a thoroughgoing review of the value for money being obtained from major spending programmes, focusing on the gap between what is being achieved by government spending in major areas and desired outcomes;
- setting up expert task forces to undertake a fundamental review of the major regulations that the recent ministerial review of business compliance costs determined were imposing the greatest costs on businesses;
- privatising government entities that supply private goods and services;
- not proceeding with the New Zealand Superannuation Fund; and
- not ratifying the Kyoto Protocol in advance of major trading partners and in the absence of sound analysis.

10.2 Failing such measures, we suggest that the budget will not contain a credible growth strategy. In that event it would be disingenuous of the government to continue to maintain it is serious about restoring New Zealand to the top half of the OECD income ladder.

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25 See Bryce Wilkinson (2001), *Constraining Government Regulation*, New Zealand Business Roundtable, Federated Farmers of New Zealand, Auckland Regional Chamber of Commerce and Industry and Wellington Regional Chamber of Commerce.

ROTARY CLUB OF REMUERA

WHITHER TAXES?

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AUCKLAND
12 NOVEMBER 2001

WHITHER TAXES?

Thank you for the invitation to talk to you this evening about tax reform. The topic of tax always reminds me of Mark Twain's question: what is the difference between a taxidermist and a tax collector? The answer is: the taxidermist only takes your skin.

I am not a recognised tax specialist so I will not go into the depths or intricacies of the recent McLeod Tax Review and the detail on the more exotic aspects of the international tax regime.

But what I do want to explore – from the viewpoint of tax policy – are some of the issues the McLeod report raised and perhaps should have pursued further.

There are some fundamental questions to be asked about tax such as:

- Are we a low tax country or not? Our maximum personal rate is 39 percent, but is that a good indicator of the overall tax burden?
- Are there parts of the potential tax base that are not taxed at all – such as our homes – and how can these distortions best be remedied?
- Are there some activities that are taxed irrationally because some people think it is good for us for them to be taxed – like cigarettes, alcohol and gambling?
- How bold was this report and could it have gone further?

The terms of reference of the Tax Review were to consider whether the structure of our current tax system is sound and to identify ways of improving it.

The Review began with an absolutely critical point that is too often overlooked in discussing tax, namely that tax begins with government spending. The main reason for raising tax is to fund spending programmes. Broadly speaking, governments have to raise as much money through taxes (including local body taxes) as they spend. Thus, government spending is the best broad measure of the overall tax burden.

Therefore, in New Zealand, where total central and local government spending amounts to around 40 percent of national income, the true tax rate of the average person is around 40 percent. This means that the average person spends two days or 16 hours of a five-day, 40-hour working week working for the government.

It's important to bear this benchmark in mind when making comparisons with other countries. At 40 percent of gross domestic product (GDP), government spending in New Zealand is higher than the average of countries belonging to the Organisation for Economic Cooperation and Development (OECD) (around 38 percent). It is much higher than in countries like the United States and Ireland where the figure is around 30 percent, not to mention Singapore and Hong Kong where it is under 20 percent. Thus, New Zealand is a highly taxed country whereas we should be aiming for a tax burden that is lower than that of comparable countries to improve our economic performance.

People are sometimes confused about the level of this tax burden because they look at New Zealand's top personal tax rate of 39 percent and note that it is not higher than many other countries' top tax rates. For example, the top tax rate in the United States was 39.6 percent before the Bush administration's tax cuts this year.

But this comparison is misleading. The 39 percent rate in New Zealand applies to a much broader base of income than is the case in many other countries. Like the old New Zealand system, their tax regimes often have multiple deductions and concessions that limit the amount of income on which people pay tax. Moreover, New Zealand's top rate cuts in at $60,000 whereas the similar rate in the United States did not apply until earnings exceeded about NZ$700,000. New Zealand also has a comprehensive goods and services tax (GST), so that the combination of a 39 percent income tax rate and a 12.5 percent GST amounts to an effective tax rate of nearly 47 percent once income is spent. This rate is more than three times the top tax rate on salaries and wages in Hong Kong, which has no GST or its equivalent. For these and other reasons, the government spending ratio more accurately measures the tax burden. Bear in mind also that many countries have been reducing their top tax rates whereas New Zealand has recently gone in the opposite direction.

Big government and high taxes are bad for economic growth. No country has achieved sustained annual growth rates of 4 percent or more with government spending amounting to 40 percent of the economy. Our present government's plans to restore New Zealand to the top half of the OECD income rankings are not credible at current levels of spending and taxation. A recent study undertaken for the New Zealand Business Roundtable by Winton Bates estimated that if New Zealand had levels of government spending similar to the United States or Ireland, our sustainable annual growth rate would be at least half a percentage point higher over 10 years – say 3 percent instead of 2.5 percent, a substantial 20 percent improvement.

High government spending undermines growth in a number of ways, and an important one is because of the so-called deadweight costs of taxation. Taxes harm incentives to work, save, invest and take risks. If you tax something you usually get less of it. People who argue for higher taxes on tobacco or alcohol understand that such taxes reduce consumption of those products. The McLeod Tax Review seriously questioned the tax policy rationale for these taxes.

In the same way, taxes on income discourage productive work and investment. Franklin Roosevelt recognised this point at a time when taxes were far below today's levels. As he put it:

> Taxes are paid in the sweat of every man who labors because they are a burden on production and are paid through production. If those taxes are excessive, they are reflected in idle factories, in tax-sold farms, and in hordes of hungry people, tramping the streets and seeking jobs in vain. Our workers may never see a tax bill, but they pay.

That quotation should be on the wall of every minister of finance.

The Review noted correctly that the deadweight or efficiency costs of taxation are generally highest at the top end of the rate scale. The marginal economic cost per dollar of taxes rises with each dollar of tax imposed. To get the greatest contribution to growth for a given loss of revenue, high rates of tax should be reduced. The Review calculated that a $1 billion cut in government spending would enable the top personal and corporate tax rates to be cut to around 31 percent.

After the problem of the high tax burden arising from government spending, the problem of high tax rates – the top personal and company rates and the high effective rates faced by people moving from welfare benefits to paid work – are the most serious problems with the current tax system. The Review did not address the tax-benefit problem but it recommended moves towards a much lower and flatter tax scale, with a top income tax rate for individuals, companies and trusts of 33 percent in the first instance and a lower rate of 18 percent for income up to $29,500.

There are always strong political pressures to redistribute income by taxing people on higher incomes heavily. As George Bernard Shaw once said, "the government that robs Peter to pay Paul can always depend on the support of Paul". But is this a wise policy?

Virtually the only argument that is raised against cutting top tax rates is that it benefits better-off people. This is inevitable because better-off people pay most of the tax the government collects. In the current financial year the top 2 percent of individual taxpayers will pay around 22 percent of total income tax, the top 12 percent will pay 50 percent and the top 45 percent will pay 85 percent. You can't reduce the taxes of people who don't pay any.

More importantly, cutting high tax rates doesn't only benefit better-off people. The most important benefit is that it improves incentives for productive effort and stimulates economic growth – the exact opposite of what happens when you increase rates.

Strong growth does far more for people on low incomes than any feasible amount of income redistribution. Even though only about 10 percent of taxpayers currently pay tax at the top rate, they are not always the same 10 percent – people's income in retirement typically falls while others are moving up. Many more people are therefore affected by the top rate. Thus, tax cuts are not a zero-sum game: gains at the high end do not come at a cost to the lower end.

Other relevant arguments can be made. Evidence shows that cutting high tax rates can lead to an increase in tax payments as higher income earners work harder and reduce tax avoidance planning efforts. Those on higher incomes would still pay much more than those on lower incomes even with a proportional tax. With a single rate of tax of 20 percent, for example, a person earning $200,000 pays tax of $40,000 whereas someone on $30,000 pays only $6,000. Thus, even a flat tax involves significant redistribution, especially because in practice it would be accompanied by a rebate mechanism as at present for low-income earners. The fiscally neutral proportional tax rate is 25 percent. Most income redistribution occurs because of expenditure on education, health and social welfare benefits to people who pay little or no tax.

The folly of looking at tax policy primarily in terms of redistribution rather than growth is best illustrated by reactions to the proposal to limit any individual's tax liability to a maximum of $1 million. The aim of this recommendation is to retain top entrepreneurs and professional people and attract others from abroad rather than have them use their talents elsewhere. As the Review noted, people earning income at these levels are of critical importance to New Zealand because of their international connections and ideas. The Review estimated that the government would actually gain revenue from this step: its choice may be to get $1 million if a taxpayer stays or get nothing at all if they go. There would be gains all round from this move. The reasons for rejecting it can only be based on ideology or envy; they clearly have little to do with the benefits to the economy or government revenue.

There are other compelling arguments for moves towards a lower and flatter tax scale. Most of the problems with the present income tax structure come from the wide spread of rates. This makes for complexity, cost, abuse and distortion. It benefits accounting firms like mine as well as tax lawyers, but not many other people.

The list of such problems is a long one. The increase in the top rate to 39 percent required 47 pages of new tax law and has made the fringe benefit tax regime a nightmare for employers. The distortions associated with the tax treatment of housing that the Review drew attention to – and which warranted a principled debate – would be reduced with lower tax rates. The same goes for the non-taxation of certain capital gains. Many of the problems with the tax treatment of savings arise from the progressive scale. Income splitting would be less of an issue with a narrower spread of rates. Lower rates would reduce the problems associated with the international tax regime. This list is not exhaustive.

If New Zealand's income tax scale were similar to that of Hong Kong – which has a top rate of 15 percent on salaries and wages and a company rate of 16 percent – we would not be having these debates. Even top income tax rates in the 20–25 percent range would greatly reduce many of the problems – in its submission to the Review, the Business Roundtable recommended a reduction in all rates to a maximum of 25 percent as a medium-term goal. It should not be hard for politicians to make arguments of this kind against views that do not stack up on either efficiency or equity grounds.

Business tax rates should be reduced along with personal tax rates, but there should not be a disproportionate focus on them. It is true that companies are the initial source of a good deal of tax – currently companies account for 15 percent of total revenue, far more than they were paying 10 years ago when Council of Trade Union economists were complaining that the tax changes of the 1980s had grossly benefited businesses. But companies are ultimately owned by individuals, and with the imputation system it is individuals who ultimately bear tax. Thus for New Zealand shareholders the key issue is their personal tax rate. For foreign investors the Review has rightly argued the case for a lower tax rate on equity investment, just as they face a lower tax rate on debt investment. Contrary to some media commentary, this would not be a concession to foreigners because any tax they bear is generally passed on and results in a higher cost of capital for all New Zealand firms – it is not paid by the foreign investor. Nor does a lower tax rate for non-resident investors competitively disadvantage New Zealand-owned firms. A tax regime that taxes foreign investment lightly has been an important factor in Ireland's economic success.

The McLeod Tax Review found that the broad architecture of New Zealand's tax system, as it has been reshaped over the last 15 years, is sound. It rightly rejected proposals for new or alternative taxes. It highlighted the case for particular attention to the international tax regime. I agree with its conclusions with two important qualifications.

First, as I noted earlier, the overall tax burden is much too high. This is imposing a heavy penalty on New Zealand in today's open international economy. There is not a lot of scope for improving the tax system unless the government's overall revenue requirements are reduced.

Secondly, the full benefits of the reshaping of the tax system in the 1980s were dependent on the directions of reform being maintained. The essence of the reforms was the creation of two broad tax bases, consumption and income, and low rates on both.

This conception has only been partly realised. On the consumption side, a raft of poorly justified excise taxes have been left in place, as the McLeod report argued. On the income side, the aim was to reduce tax rates well below present levels. Recall that the company rate was at one point reduced to 28 percent; it is now 33 percent. Roger Douglas aimed for a flat personal and company tax rate of around 22–23 percent. The much higher tax rates that we have ended up with have created a greater bias against savings in the tax system than was intended, led to the complexities I have mentioned, and failed to realise the gains that a more coherent reform package would have delivered.

Until the previous direction of tax reform is reaffirmed, I believe there are risks of further unravelling, pressures to reintroduce concessions and incentives, and a return to interest group privileges and favours. Thus, the McLeod Tax Review comes at an important time. The government's budget is clearly under stress and New Zealand faces a risk of higher rather than lower taxes over the next few years. It was disappointing that the government summarily rejected key recommendations of the report, which I believe are widely supported by the business and professional tax communities. Politics must not be allowed to close off the debate. There is a need for serious engagement with the issues that have been raised. Tax policy should be a major issue for political parties going into the next election.

INDUSTRY POLICY AND REGULATION

NEW ZEALAND ASSOCIATION OF CREDIT UNIONS
ANNUAL CONFERENCE

TRUST, MARKETS AND GOVERNANCE

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NEW ZEALAND BUSINESS ROUNDTABLE

NELSON
14 SEPTEMBER 2002

TRUST, MARKETS AND GOVERNANCE

Recently, the New Zealand Business Roundtable hosted a visit by the American writer and academic Francis Fukuyama, who has made major contributions to the understanding of modern trends towards democratic government and market economies.

I want to organise my remarks today around the theme of his 1995 book *Trust*, which carries the sub-title 'The Social Virtues and the Creation of Prosperity'. The issue of trust in commerce is highly topical, as prominent cases of business misconduct have been in the headlines around the world. It is also central to the philosophy of the credit union movement.

Trust requires distinguishing between those who just talk the talk and those who walk the walk. Here is a quotation from a company's corporate responsibility report:

> Since establishing our corporate responsibility function, … we have focused on strengthening internal awareness and governance of social and environmental issues facing our business …
>
> We will … integrate human health, social and environmental considerations into our internal management and value system …
>
> [In addition, we have] enhanced our efforts to engage external stakeholders on human rights, biodiversity, indigenous rights, transparency and performance measurement.

Which company was that? You guessed it: Enron, just a couple of years ago. Enron was America's triple bottom line company par excellence.

But it wasn't the only one. WorldCom was ranked in the top 50 companies in the world for corporate responsibility in the FTSE4Good Index. The Swedish firm Asea Brown Boveri (ABB) preached the same gospel but was the subject of a scandal this year when two of its officers walked away with US$136 million of retirement benefits between them. They ended up giving half of it back, but not before the company's reputation was in tatters and its share price trashed.

It pays to be sceptical about companies that parade their virtues. Too often their motives are self-serving. For years I have had a simple investment rule. If a company starts proclaiming how socially responsible it is or buys a corporate jet, I sell my shares. Judge Corporation did both. I haven't lost money yet by following that rule.

Of course businesses have social responsibilities, which include making money for their owners, treating all stakeholders fairly and being environmentally responsible. They may want to report publicly on their plans and performance under these headings. But does it make sense to talk of a firm having a 'triple bottom line'? That might be reasonable if there were objective, measurable standards for social and environmental reporting comparable with those for financial reporting, whereby company officers could be charged for fraud and officers and auditors could be sued for negligence. But of course there aren't. We should discuss each role in its own terms, not in slogans. With multiple goals, managers cannot be held accountable for their primary duty to deliver maximum shareholder benefit – they always have the excuse that they were pursuing other goals. And why stop at three bottom lines? Companies should certainly have an ethical bottom line and a bottom line for corporate governance, to name just two more. Enron obviously came up several bottom lines short.

The Enron affair and other corporate scandals have triggered an avalanche of proposals for new regulations and changes to corporate governance. Debates on both aspects are healthy, but there is a serious risk of overkill. Some basic perspectives need to be kept in mind.

The first, and in some ways the most important, is to remember how the wrongdoing was discovered and punished. It wasn't the work of regulators. The Enron scandal was revealed when a private investor found oddities in Enron's reported accounts. And the market didn't wait for a trial and conviction to send the company packing – the death penalty was immediate. Not only that, but the accounting firm Andersen, then one of the world's 'big five', went down with Enron because of its role in helping to cook the books. The share prices of other companies that came under suspicion were quickly marked down.

The point here is that trustworthiness and reputation are priceless assets in business – without them, firms put their very existence at risk. The market's capacity for self-correction was demonstrated long before regulators or politicians appeared on the scene. It acted with a terrible, swift sword. As Fukuyama observed in a comment on the scandals, far from reducing trust, the ability of American capitalism – unlike crony capitalism in Asia or Russia – to expose misconduct and hold people accountable provided the basis to rebuild trust.

Another point made by Fukuyama relates to the greedy behaviour of some corporate executives. Greed, he pointed out, is an unattractive aspect of human nature that exists in all societies, regardless of their economic systems. Greed has to be constrained by institutions, laws and informal norms. Commentators have suggested that two changes in constraints in the United States made the problem worse. First, moves since the 1980s to make takeover regulation more restrictive made it more difficult to punish corporate incompetence and extravagance, and in the absence of this discipline too much emphasis was placed on remuneration incentives to align the interests of shareholders and company officers. Secondly, a 1993 law required annual bonuses greater than US$1 million to be tied to the company's performance or the bonus would not be tax-deductible. This created incentives for company executives to inflate reported earnings. Not for the first time did a government intervention have unintended and perverse consequences.

These lessons should be remembered when considering proposals for new regulatory controls. One popular idea is to require share options granted to employees to be treated as current expenses in financial reports. This probably has some merit, but not too much should be hoped of it: changes in accounting treatment don't alter share prices so long as information is disclosed; difficult issues of accounting are involved; and it is easy to foresee claims that alternative treatments are misleading. Similarly, requiring chief executives and chief financial officers to certify the accuracy of reports seems attractive, but it is questionable how far that would change existing practice – it is already the case in New Zealand that two directors, one of whom is usually the managing director, are required to sign financial statements. Pushing this requirement further may drive up executive salaries and liability insurance to compensate for additional risk; it could lead people to believe in the impossible – indisputable accounting; and to play safe, executives could shun risk taking that would benefit shareholders and promote economic growth.

Similar problems are posed by other fashionable ideas, such as prohibiting accounting firms from offering audit and non-audit services to the same client, requiring rotation of auditors, and regulating accounting standards. The basic issue is not whether some of these ideas have merit but whether decisions about them should be made by firms or regulators. Telecom, for example, has already announced that it will expense options when an accounting standard has been drawn up, and some accounting firms have moved to set up their consulting arms as separate entities. These are voluntary, market solutions to deal with problems as perceived by individual market participants. They differ from regulatory solutions which impose one-size-fits-all requirements on the whole market. A rush to legislative judgment would be foolish; as one commentator put it in the American context, "Congress does not help investor confidence by lurching around like demented bovines stomping on a complex financial and entrepreneurial ecosystem".

New Zealand and other countries have been down this path many times before. Experience suggests new laws are as likely to make things worse as to make them better. We established a Securities Commission in the late 1970s in response to corporate scandals of the time. Commerce had operated largely on the basis of the common law and without the benefit of a Securities Commission for over a hundred years in New Zealand. During that time, we became one of the richest countries in the world. Since 1978, tens of millions of dollars have been spent on the Commission and on complying with its rules. Are we better off as a result? I don't know the answer to that question, but it is not self-evident.

New Zealand has a chronic habit of passing more laws rather than enforcing laws we already have. There are endless calls, for example, for new legislation on insider trading – a problem, incidentally, of minor significance in our markets. Yet there is a law against insider trading on the statute books, and although it was a botched piece of work by the Securities Commission, at least it provides remedies for shareholders. Frustrated by the absence of initiatives to enforce it following a clear-cut breach by a former chairperson of Fletcher Challenge, I joined with another shareholder in a successful action. We have set up a trust to help others take similar cases.

But mention of Fletcher Challenge brings to mind a far more important issue of corporate governance that is relevant to this discussion. The insider trading case was not the worst of its kind, and the board acted with commendable swiftness to insist that its chairperson stand down. The much more egregious aspect of Fletcher Challenge's performance was the billions of dollars of shareholder value that was destroyed in the period when Hugh Fletcher ran the company. Those losses may have been the largest in New Zealand's business history. They were aided by failures of corporate governance, including an employee share scheme that served as an anti-takeover device, the adoption of restrictive listing rules that also inhibited takeovers, and effective management control of the board via the presence of several executive directors.

It is also worth noting that the problems of Enron and WorldCom arose in the first instance from bad business decisions. The accounting irregularities were an attempt to cover them up. Better audits might have warned investors a little sooner about the insolvency of those companies, but they would still have gone bankrupt.

It follows that any discussion of corporate governance in the wake of these scandals must keep firmly in mind the main role of the corporation – to benefit shareholders and the wider community. This requires entrepreneurial initiative and risk taking. It is impossible to earn profit without an element of risk. If we criminalise risk taking we will simply get less of it.

Generally speaking, corporate governance in New Zealand is in line with international best practice. Typically, New Zealand boards have a relatively small number of directors, an independent chair, a substantial majority of non-executive directors, and audit committees independent of management. Accounting practice and information disclosure are also generally of a high standard. While there is always room for improvement, the last thing we need is company boards populated by lawyers to ensure compliance with rules; liability exposures that deter talented people from accepting board appointments; and a regulatory environment that is so utopian in its drive to eliminate wrongdoing that it stifles wealth creation and makes the New Zealand market and economy uncompetitive.

For, in the final analysis, our market system depends on trust and integrity. Not even the most primitive exchanges can take place if one party cannot trust the other to deliver on their side of the bargain. Laws and institutions can encourage ethical behaviour and check excesses, but they can only take us so far. You can’t legislate for honesty. The attitudes and actions of chief executive officers (CEOs) to a very large extent determine corporate conduct. As President Bush put it recently:

> … ultimately, the ethics of American business depend on the conscience of America’s business leaders. We need men and women of character who know the difference between ambition and destructive greed, between justified risks and irresponsibility, between enterprise and fraud. Our schools of business must be principled teachers of right and wrong, and not surrender to moral confusion and relativism.

This brings me back to Fukuyama, trust, and the role of civil society – of which businesses such as credit unions are a part. Fukuyama points out that if the government intervenes too much to structure social relationships, it runs the risk of supplanting the ability of civil society to organise spontaneously. Civil society, he says, is:

> … a complex welter of intermediate institutions, including businesses, voluntary associations, educational institutions, clubs, unions, media, charities, and churches. [It] builds, in turn, on the family, the primary instrument by which people are socialized into their culture and given the skills that allow them to live in the broader society and through which the values and knowledge of that society are transmitted across the generations.

As the Maxim Institute noted recently, the essential qualities of trust, reliability and accountability that are vital to successful business are learned primarily in the functioning family. We need families to teach children that stealing is wrong if we want business people to understand that fraud and deception are thefts of property. We need schools to teach values, not just engage in ‘values clarification’. Without shared social norms, values and ethical standards that go beyond laws, the transactions costs and risks of doing business become prohibitive, as the experience of Russia demonstrates. The United States is a highly successful economy in part because – as the response to the events of September 11 reminded us – it is a high-trust, group-oriented society, despite its individualistic traditions.

Institutions of civil society such as friendly societies and credit unions were damaged as the state assumed responsibilities for welfare and mutual aid that they once discharged. Credit unions are now under some threat from the establishment of Kiwibank – particularly if it fails to succeed commercially, gets propped up by the government and creates unfair conditions of competition with other financial service providers. This is all the more reason why credit unions should have the chance to operate on a level playing field without handicaps. I think you have a legitimate complaint that many of the current statutory rules applying to credit unions, such as those relating to capital raising and to the setting of fees and charges, are unduly restrictive.

I believe the government should be looking to establish rules based on sound principles that apply generally with fewer special regimes that apply narrowly. The general direction of policy relating to saving and investing over most of the past century was to regulate more heavily with the aim of protecting investors from losses. While this may have protected some people, such regulations involve costs. Losses from fraud, incompetence and market factors will not be avoided. More regulation is particularly hard on smaller organisations, because costs usually fall disproportionately on them. We would do better to put more reliance on general protections against dishonesty, on the principle of *caveat emptor*, and on competition.

Similarly, I would argue that the tax treatment of credit unions should be neutral relative to other entities. I would not favour special tax concessions, but the mutual principle that a mutual association cannot derive a taxable profit by trading within its circle of membership, and the principle that organisations that are not-for-profit should be exempt from income tax, should apply.

Finally, there should be no outside pressure to change your mutual form of organisation. Mutuals, cooperatives, partnerships, corporations and other forms of business organisation all have a role to play in commerce. In a competitive environment without special privileges, it is the business of their owners to decide whether any changes in organisational form are warranted. But high standards of corporate governance are as important in mutuals as in any other businesses. Those running credit unions should be properly accountable for delivering maximum benefits to your members, and exposure to competition should spur you to do that.

Let me sum up. All of us in the business community are thinking about the lessons of Enron and other scandals for market rules and corporate governance. Public indignation over the abuses is fully justified. It would be good to see the fraudsters put behind bars. They have hurt the reputations of honest companies, shaken trust, damaged the sharemarket and affected millions of people who depend on the integrity of business for their livelihood and their retirement.

In the wake of these events, the same mistakes won't be repeated in hurry – at least for a time, people will be on their guard and financial probity will be valued. Enron won't be the last corporate scandal, but the changes in market transparency and corporate governance that are occurring will make future Enrons less likely. The self-correcting properties of markets are one of their strengths. There are some things that need to be fixed. Corporates and professional firms in New Zealand are changing some of their practices, the Stock Exchange is reviewing some of its listing rules, and the Institute of Chartered Accountants has put out a useful discussion paper on corporate transparency. These things have happened without government prompting.

Because New Zealand avoided the worst of the recent excesses, the corporate hero-worship and the mindless enthusiasm for the so-called 'new economy', the fallout here has been less severe. But over the years we have not been immune from corporate misconduct and, especially, failures in corporate performance that have destroyed large amounts of shareholder wealth. The weaknesses that have been revealed in corporate governance need to be remedied but, as Fukuyama notes:

> You would not want corporate governance to simply be a matter of draconian punishment or the micro-management of the accounting process because a lot of that *does* have to rely on values.

Business is an honourable vocation. The great majority of New Zealanders work in business. Most of them are honest people. There are abuses in business but governments are even more prone to cooking the books. These things happen because men and women are not angels and their tendencies to opportunism need to be constrained by institutions, laws and shared values. Failures in business occur in large and small firms alike, and the remedies are much the same – there are no great differences between the needs and interests of large and small businesses. It is incumbent on all of us in business to reflect on the lessons of recent events, strive for high standards, earn the community's trust, resist ill-considered reactions that would do more harm than good, and remember above all else that if we want faster growth and higher incomes for all, we must have an environment that encourages rather than stifles business enterprise.

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION TO THE NEW ZEALAND STOCK EXCHANGE ON PROPOSED LISTING RULES ON CORPORATE GOVERNANCE

SEPTEMBER 2002

1.0 Introduction

1.1 This submission on the proposals by the New Zealand Stock Exchange (NZSE) for Listing Rules on corporate governance (CG) 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.

2.0 Importance of corporate governance

2.1 The NZBR acknowledges and fully endorses the importance of sound CG practices by public companies and listed issuers. However, we do not believe there is any such thing as "the full universe of CG best practice" alluded to in the Foreword of the NZSE document. Best practice in CG internationally is recognised as depending on the culture and the business and legal environments of each country and the circumstances of individual companies.[1]

2.2 The main aim of CG is, or should be, to improve the performance of companies. Conformance with rules does not assure performance. Boards have a "responsibility to exercise governance so as to ensure the long-term successful performance of their corporation".[2]

2.3 Boards in New Zealand, like most countries outside Europe, have a unitary structure. There is a strong body of thought in unitary board countries in favour of separating the chief executive/chairperson roles and having a majority of independent directors on boards. We are quite sympathetic to that thinking. However, there is no strong evidence in the finance literature that such a board structure has any effect on performance or can be referred to as 'best' practice. Nor is the practice universal: executive directors make up 60 percent of the total membership of British boards, and up to 90 percent of US companies combine chairperson and chief executive roles.[3] The arguments for the separation of these roles and the use of more independent directors cannot be divorced from the complete set of CG practices followed by a board. Best results appear to come when all directors understand and accept their dual responsibilities: the managerial role – to drive the company forward – and the self-regulatory role – for assuring the right conduct.[4]

2.4 The approach generally favoured in advanced countries is not to be prescriptive about corporate governance rules. Prescriptive regimes may be more appropriate in environments where there is less transparency and accountability – through media and other forms of scrutiny of corporate performance – and less of a culture of ethical conduct. It is not obvious that being prescriptive about the number of independent directors and their degree

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1 International Task Force on Corporate Governance of the International Capital Markets Group (ICMG) (1995), 'International Corporate Governance: Who holds the Reins?', ICMG, New York.

2 The (US) Business Roundtable (1990), 'Corporate Governance and American Competitiveness', US Business Roundtable, New York.

3 'Gloom at the top', *The Bulletin*, 3 September 2002, p 46.

4 Francis, Ivor (1997), 'Future Direction: The power of the competitive board', FT Pitman Publishing, Melbourne.

of independence helps performance, and it will certainly add costs for some companies. The definitions of what constitutes independence can be arbitrary.

2.5 If the NZSE is determined to establish the independence of independent directors, it would be preferable to get companies to disclose the extent of the dependence of directors who have a professional association (for example, as lawyers or accountants) with the company. Companies already disclose substantial security holdings and directors' holdings. There are mixed views about whether directors should hold and be rewarded with stock, or are no longer independent if they do so. The evidence that this makes a difference to performance or governance is equivocal. We consider the NZSE might recommend practice in this area, but should not prescribe compliance.

3.0 Directors' competence

3.1 Shareholders have the responsibility to appoint directors. In our view it is not for the NZSE to determine the suitability or qualifications of directors. The NZSE may well incur responsibility and liability for the performance of directors if it declares they are suitable by dint of a form of 'licensing' through approved qualifications. Courses on the role and duties of directors are already provided by the Institute of Directors and other organisations and may be valuable for some. Efforts to improve training programmes and to encourage director education in other ways are to be commended. However, there is no evidence that compulsion is justified. The proposals for certification will add compliance costs and provide no guarantee of improved performance.

4.0 Audit

4.1 The requirement for an audit committee reflects standard good practice and should not impose an additional burden on listed issuers. However, the NZSE should not prescribe the qualifications and experience of those who are to perform that role. This would have cost implications that have not been justified, as would prescribing the roles and responsibilities of audit committees. The footnote and Code suggestion that auditors should not also be financial consultants has not been shown to be needed in New Zealand. Where is the evidence that there is a problem? The proposal would have substantial cost implications for some issuers.

4.2 There are practical difficulties in New Zealand with the limited number of major audit firms. Rotation of audit partners rather than firms is less likely to create difficulties or shortages. We also consider it has not been established that New Zealand accounting firms are unable to separate properly their audit responsibilities from their consulting and advisory services businesses where this is necessary. We would prefer solutions to any genuine problems to be implemented voluntarily by individual market participants rather than imposed on all.

5.0 More rules and regulations are the wrong response

5.1 The NZBR recently made a submission to the Ministry of Economic Development on proposals to change securities trading legislation (a copy of which was sent to the NZSE). We noted that in the absence of a sound framework for policy analysis, undue weight may be put on ill-examined presumptions, such as the notions that:

- New Zealand will attract more overseas capital with more extensive prescriptive regulation;
- New Zealand will attract more overseas capital from a country if it harmonises its regulations with that country;
- more laws can lift standards of behaviour;
- prices will more accurately track the underlying values of securities if market participants are better informed through mandatory disclosure; and
- New Zealand markets would be 'the last frontier of the Wild West' without the extensive legislation of the last 20 years or more.[5]

5.2 There appear to be presumptions in some quarters that regulations exist in other countries because they produce net social benefits. However, in the words of a major textbook on the economics of regulation, this view "has lacked supporters for several decades" in part because "a large amount of evidence … refutes it".[6] The NZSE should not climb on the bandwagon of regulation and apply the same thinking to its Listing Rules.

5.3 The proponents of more regulations and prescriptive rules have often simply assumed that they will efficiently achieve their stated goals. In many cases, the experience in New Zealand has been that regulations have raised the costs, risks and uncertainties of dealing in markets without producing any obvious or demonstrable gains, or reducing the inexorable pressure to increase those burdens further.

5.4 The small New Zealand market cannot be expected to remain competitive under the burden of intrusive rules and monitoring and enforcement structures that are designed for much larger markets. Offshore regulators have a natural interest in pressuring New Zealand governments to adopt their regimes. There is no hope for the future competitiveness of our capital markets if evidence that we are losing competitiveness is used to justify additional regulatory and self-regulatory burdens in order to 'promote confidence'.

5.5 The only safeguard against these debilitating trends is better analysis and a greater sense of constraint in removing shareholder choice and freedom of contract. It is disappointing to find that the commentary on the CG proposals sets out a policy intention rather than the necessary analysis. The NZSE should not weight the responses it gets to its request for submissions on the basis of the numbers in support of particular views but on the quality of the analysis presented.

5.6 We believe shareholders should be free to choose for themselves the regime of governance that is best for their company. If the NZSE is determined to proceed with a prescriptive CG regime, one option we urge for serious consideration is to allow shareholders to opt out of the prescribed regime by resolution at a general meeting.

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5 *Submission to the Ministry of Economic Development on the Reform of Securities Trading Law* (2002), New Zealand Business Roundtable, Wellington, August.

6 Viscusi, W Kip, Vernon, John M, and Harrington Jr, Joseph E (1995), *Economics of Regulation and Antitrust*, The MIT Press, Cambridge, Massachusetts, 2nd edition, p 326.

6.0 Actions to improve credibility and confidence

6.1 We note the NZSE's statement in its commentary that its proposals are important "to market credibility and enhancement of market confidence". The proposed note for the Foreword refers to the "value that a strong governance framework brings to capital markets and capital market participants". However, there is no measure of the current level of confidence and no evidence that it is low. Nor is there evidence that the current governance practices of listed issuers are not "strong". No reason is given for believing that further prescriptive rules will raise, rather than lower, the level of market confidence and will add "value". The high weighting of overseas investment in our market rebuts the view that New Zealand has to succumb to pressures from overseas regulators to adopt their rules and regulations in order to maintain market confidence.

6.2 The objective of enhancing confidence per se looks ad hoc and overly narrow in ignoring the importance of having a competitive capital market. The objective implies that the NZSE would be satisfied if it achieved high confidence in a market that had become so uncompetitive and inefficient as to be insignificant. Confidence should come from appropriate transparency and disclosure, rather than through any attempt to prescribe a uniform approach.[7] Few would argue that confidence in a market can be increased by imposing unnecessary rules. They generate disrespect for rules and an attitude of non-compliance. This is highly corrosive.

6.3 The performance of stock exchanges reflects the performance of listed issuers. This in turn is influenced by the performance of the economies in which they operate. Growth in the market in general depends ultimately on growth in the economy. Thus, instead of increasing compliance costs for listed issuers, the focus of the NZSE should be on encouraging the government to adopt policies and take actions that will encourage economic growth in New Zealand.

6.4 We are confident the NZSE is serious about promoting the performance of the New Zealand sharemarket and would therefore expect it to:

- discourage the government and media from attacking our market as 'the last frontier of the Wild West';
- argue strongly for the protection of property rights (as in the Vodafone case, the proposed Kyoto measures and the restructuring of the electricity sector by the previous government). Property rights should not be taken without due process and compensation;
- discourage the Securities Commission from attacking major companies or the market in general, perhaps in order to boost its own profile, regulatory powers or budget. (Its impulsive and incorrect attack earlier this year on Telecom New Zealand's accounting standards illustrates our point.);
- remind the government that the 39 percent marginal tax rate creates the impression that it favours higher tax rates on investor income;
- lobby the government to reverse its anti-privatisation stance so that companies like New Zealand Post, electricity state-owned enterprises

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[7] See ICMG study, *op cit*, p 10.

(SOEs) and local authority trading companies have a chance of being listed on the NZSE;

- encourage a reversal of the presumption in favour of the harmonisation of regulatory regimes, recognising that smaller markets have less need for and are less able to sustain the costs of expensive regimes. New Zealand must seek to be more efficient if its capital markets are to compete with Australian exchanges for Australasian business;
- set an example to the government by not proposing changes to its Listing Rules that are not supported by an independent, professionally competent impact statement;
- promote a national strategy for economic growth that is credible in the eyes of investors.

6.5 The current regulatory approach and dynamic seem likely to make New Zealand's capital markets less liquid and less attractive for capital raising. An object lesson for us should be Tasmania, which is subject to the same regulations as the rest of Australia. Its capital markets have no visibility in an Australasian setting. If New Zealand continues to adopt regulations and rules designed for much bigger and more liquid markets, we can expect our capital markets to become increasingly inefficient, insignificant and invisible. The current trend for global investment banks to exit New Zealand should heighten this concern. We suggest that the NZSE should think carefully before introducing inflexible CG rules that do not allow for differences in the size, nature or style of issuer and its governance.

7.0 Conclusion: the NZSE's review process

7.1 The case for more regulation of corporate governance is not established. We are not aware of evidence that current New Zealand practices are unsatisfactory or that, generally speaking, there is any harm being done that the NZSE proposals will correct. The commentary associated with the proposals falls well short of a rigorous review:

- It does not establish why the stated aims of "accountability, transparency and certainty" and "enhancement of market confidence" would not be achieved by a reporting approach, that is, the disclosure of the CG practices of issuers as required under the current rules (LR 10.5.3.(h)). Why is this inadequate? A reporting approach is consistent with the commitment to disclosure requirements in paragraph 8 of the Foreword. Shareholders are entitled to regular information about their company's CG practices, performance and prospects. In this regard we would expect the NZSE to respect materiality in the reporting of practices which differ from any recommended Code.
- The prescriptive approach to CG appears to be at odds with the underlying principles of the Listing Rules set out in the Foreword. It represents a form of merit regulation that seems inconsistent with paragraph 2 of the Foreword which advises that such an approach would "offer a spurious assurance to investors".
- The NZSE does not need to make precipitate changes to its Listing Rules. In the wake of the Enron and other scandals, regulators and markets around the world have rushed into more regulation of market

practices and conduct. Often, sound analysis of the policy and framework of securities market regulation has not been undertaken and further changes may be expected. The same problems have not occurred in New Zealand. We think the NZSE should work with the business community (for example, the Institute of Directors (IOD)) to formulate a voluntary code that meets New Zealand needs. Indeed, it is not clear that the existing IOD Code is unsuitable for that purpose.

- The proposals should have academic and empirical support. The NZSE, as the dominant market service provider in New Zealand, with a need to establish a reputation for quality, should adopt high standards of analysis. It should publish professionally competent impact statements on the proposed rule changes that would gain the support of New Zealand's leading academics in finance or regulatory economics. Development of suitable local CG codes should involve a process of research, consultation and feedback. We commend the decision to defer implementation of the Listing Rule changes and urge that the consultation process should be extended with the aim of reaching a high level of consensus about desirable changes.

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON
CLIMATE CHANGE: THE GOVERNMENT'S PREFERRED POLICY PACKAGE

MAY 2002

SUBMISSION ON *CLIMATE CHANGE: THE GOVERNMENT'S PREFERRED POLICY PACKAGE*

1 Introduction

1.0 This submission on the discussion document *Climate Change: The Government's Preferred Policy Package* 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 This submission should be read in conjunction with our submission in March 2002 on the document *National Interest Analysis of the Kyoto Protocol* and our submission in December 2001 on *Kyoto Protocol: Ensuring our Future*. These submissions have made the following points:

- global warming is an issue that has to be taken seriously;
- the science of climate change remains uncertain, both in respect of the rate of future growth in emissions and the effects of a doubling of atmospheric CO_2;
- at the 3°C mid-point of the range of temperature increases projected by the Intergovernmental Panel on Climate Change (IPCC) for a doubling of atmospheric CO_2, the rise for New Zealand would be only 60 percent of this increase or 1.8°C, according to the National Institute of Water and Atmospheric Research (NIWA) estimates;
- the effects of this degree of warming on New Zealand agriculture and forestry and on fuel consumption and human health could well be beneficial;
- Kyoto will not prevent projected warming, nor materially delay it;
- effective global action would require the participation of the United States, China and India. The United States currently accounts for about 25 percent of global emissions and China and India are expected to account for around half the world's emissions by 2012. Participation by these countries is not currently in prospect. Canada's participation is now also in doubt, as a result of its concerns about a loss of competitiveness vis-à-vis the United States;
- cost-benefit assessments indicate that the global costs of delayed action are much lower than the costs of precipitate early action by a few countries;
- ratification by New Zealand would impose large economic costs for negligible environmental gains; and
- it is in New Zealand's interests to improve our relationships with Australia and the United States, not to diverge from these countries on yet another issue.

1.3 On these grounds the NZBR has opposed ratification of the Kyoto Protocol by New Zealand in advance of similar action by major trading partners, including the United States and Australia, and pending a rigorous analysis demonstrating that ratification is in New Zealand's interests.

2 The government's response

2.1 In the discussion document the government proposes to meet New Zealand's Kyoto commitments by:

- continuing with existing 'foundation' policies, in particular with respect to energy efficiency and energy conservation, waste management and research; and
- implementing the following main new policies if the Kyoto Protocol comes into force:
  - utilise sink credits generated by post-1990 forestry planting. These would be retained by the Crown;
  - exempt agriculture from emissions charges for methane and nitrous oxide, but require farmers to fund research;
  - enter into Negotiated Greenhouse Agreements with Competitiveness-at-risk firms; and
  - impose an emissions charge in the first commitment period, capped at $25 per tonne of CO2 equivalent.

Other less significant measures are also envisaged.

2.2 The overall 'balance sheet' of measures based on existing policies that would enable New Zealand to meet its Kyoto obligations in the first commitment period is presented in the discussion document as follows:

	Estimated Mt CO_2 equivalent for 2008–2012
Projected emissions, business as usual	440
Assigned amount for 1990 emission levels	365
Net amount of excess emissions to be covered under business as usual in the first commitment period	–75
Existing policies	
• National Energy Efficiency and Conservation Strategy	20
• The New Zealand Waste Strategy	5
• Research	not quantified
Estimated amount to be covered after existing policies	–50
Sink credits generated	105
Estimated net positive position	55

The discussion document does not state what reductions in emissions during the first commitment period the government expects from the new policies if put in place. However, it is reasonable to assume that these will be minimal given the exemptions and the $25 a tonne price cap. It can therefore be seen that the government's strategy relies heavily on the use of sink credits – two-thirds of New Zealand's excess emissions are projected to be covered in this way.

2.3 No quantified information is presented on how the government envisages New Zealand would meet Kyoto targets beyond the first commitment period. At this point the availability of sink credits is likely to be limited and, if so, much steeper reductions in gross emissions would be required. The discussion document acknowledges this outlook by saying the government aims to set New Zealand "towards a permanent downward path for total gross emissions by 2012" while preserving competitiveness, economic growth, fairness and relativity with international developments.

3 Evaluation of the government's approach

3.1 It is pleasing that the government has recognised the severe impact that the Kyoto requirements would have on the New Zealand economy. It is no longer talking about 'leading the world' on climate change and its proposed package would cushion the cost impact in the short term. The strategy is also in line with that of some other countries – such as Germany and Russia – that can ratify Kyoto without any significant short-term pain because of changes in their industrial structure.

3.2 However, we believe there are major difficulties with this strategy. They fall under two headings: 'Issues within the first commitment period' and 'The second commitment period and beyond'.

Issues within the first commitment period

3.3 Each of the major policies on which the government is relying is problematical.

Sink credits

3.3.1 At first sight, the sink credits generated by post-1990 forests look like a 'free lunch' for New Zealand in meeting Kyoto obligations. The government has argued New Zealand could make money from them although it has acknowledged the sums may not be large, depending on the international price of carbon. It should also be recognised that sales of sink credits by the government are not net benefits to New Zealand, given the costs to firms and individuals of the measures the government plans to impose.

3.3.2 On closer examination, however, the Kyoto Protocol puts the forestry industry at risk in a number of ways:

- It is far from clear that an international market will develop for tradable emissions units in the way the government is assuming, if at all. Given that the United States and Australia do not plan to ratify Kyoto, Canada may also be out, Japan is in long-term economic difficulties, the European Union is establishing a wholly internal emissions trading market, and that Russia may control around 60 percent of the world's supply of tradable emissions, does a well-functioning market look to be a credible proposition? Which countries are likely to be buyers of forest sink credits and what price would they pay? What is proposed in this trade is the exchange of real dollars for pieces of paper declaring that country X is not burning so many tonnes of coal or other fossil fuels. It is one thing for the US government to pay its farmers large sums for not planting so many acres with corn. It is another thing to transfer massive sums across national borders in exchange for not burning fossil fuels. There will be massive complexities in determining the definition, measurement and enforcement of sink credit trading (especially given European reservations about the basic idea). More powerful countries may seek rule changes or interpretations that harm New Zealand interests.[1]

- European funding for 'clean development' could increase competition for New Zealand wood on world markets and depress prices. (Recent reports suggest the Chinese government plans to increase its forestry plantations by 13 million hectares over the next 10–15 years. This compares with New Zealand's planted production forestry area of 1.7 million hectares.)
- The 'sweetheart' deal at Marrakech to allow Russia to claim credits for its vast natural forests will depress the international value of carbon.
- Kyoto would mean higher transport and energy costs for wood processing.

3.3.3 Further problems are posed by the government's plans to "effectively nationalise" sink credits:[2]

- The government argues that allowing forest owners to retain sink credits would confer an uncompensated windfall gain. Our perspective is that forest owners have always owned the carbon that is stored/absorbed within their forests. The fact that society now places a value on that carbon store does not alter its ownership. Similar changes in the value of property rights have occurred throughout history. For example, oil had little value prior to the development of the internal combustion engine. Coal, once of high value, is of decreasing worth. If the government is unwilling to allow a windfall change in values, would it not also seek to compensate coal owners for the corresponding value loss that would result from any meaningful policy on climate change?
- Appropriation by the government of the carbon credit values in forests puts New Zealand in a net surplus position. New Zealand's fossil fuel users would face a substantially higher emissions abatement obligation if the privately owned forest sink values were not to be appropriated and redistributed by the government. In effect, New Zealand's forest owners are being compelled to subsidise private motor vehicle users and industries that compete with timber industries, such as aluminium.
- In the Kyoto negotiations the previous minister for the environment, Simon Upton, gave a commitment that the sinks available under Article 3.3 of the Protocol would be available for international trade. Land conferred on Maori by way of Treaty of Waitangi settlements was also

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1 Pages 38–42 of the discussion document illustrate some of the complexities.

2 The words "effectively nationalise" are taken from 'Report on International Treaty Examination of the Kyoto Protocol to the United Nations Convention on Climate Change' by the Foreign Affairs, Defence and Trade Committee, p 11.

assumed to incorporate property rights that included carbon credit values. The Treaty of Waitangi itself assures Maori of undisturbed possession.

- Future governments will have an incentive to regulate the harvesting and replanting of forests in order to maximise the value of the credits that have been appropriated. For example, it is conceivable that the Resource Management Act 1991 could be used to constrain harvest on the basis of total carbon storage.
- The government's decision perversely reduces the incentive to plant trees in order to absorb carbon. The law firm Chapman Tripp has noted that it:

  > … would appear to kill off creative private sector opportunity for international emissions trading, at least in the intermediate term and possibly for the first commitment period. This is likely to prevent, for the time being anyway, arrangements such as that recently announced by Waste Management New Zealand Limited, which earlier this year completed negotiations for the sale of emission credits to a North American based energy company.[3]

- Appropriation of forest carbon values amounts to a retrospective imposition of a tax on a change in land use. Forests were presumably planted in response to an actual or predicted demand for wood fibre. In the absence of such a demand the land owner has traditionally had the right to convert from forestry to a more profitable enterprise, recent examples being pastoral agriculture and urban subdivision. The introduction of carbon value to forestry internationally will have the effect of increasing the area of planted forests with a corresponding increase in global wood fibre supply. In the absence of the ability to derive an equivalent return on investment through sales of timber *and* carbon storage, New Zealand forest owners will be at a competitive disadvantage and therefore motivated to disinvest in forestry. Arguments in the discussion paper that a 5 percent cap on deforestation equates to historic land use change from forestry are irrelevant if international concerns about climate change substantially alter traditional forest values and investment patterns.

3.3.4 Uncompensated takings of property rights send a disturbing signal to domestic and foreign investors. A constitutional approach would call for compensation if ratification impairs the property rights of owners (for example, by stopping them from negotiating private offset arrangements or by imposing a potential liability for deforestation). In principle, the compensation should be funded by those who favour ratification and the taking of those property rights. In practice, this would be likely to be taxpayers at large.

3.3.5 The difficulties faced by the government in choosing between devolving and retaining sink credits and liabilities stem fundamentally from one of the many flaws of the Kyoto Protocol.

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3 Chapman Tripp (2002), *Counsel*, 'The Kyoto Protocol: one step closer to ratification', 20 May, p 4.

Research levy for agriculture

3.3.6 It is clear that the agriculture sector, which accounts for some 55 percent of New Zealand's greenhouse gas emissions, must be included in any long-term strategy for emissions reductions if New Zealand ratifies the Kyoto Protocol. The discussion document states that "The government proposes to exempt the on-farm agriculture sector from a price on non-CO_2 emissions during the first commitment period, at least", recognising that there is currently no practical alternative to reductions in stock levels to reduce agriculture sector emissions. Instead, the government proposes to "negotiate [with the agriculture sector] over funding for a sustained research effort" on methane and nitrous oxide emissions. It states that:

> If the sector is unwilling to work with the Government to invest in research voluntarily, a research levy will be imposed on the sector for research into emissions reductions.[4]

3.3.7 This threat turns a 'negotiation' into a demand. The demand is illicit if the threat is illegal or unconstitutional. Unconstitutional demands undermine trust and social cohesion. A prime role of government is to protect property rights, not to breach them by making unprincipled demands. Governments must be very careful not to abuse their power to make threats. The issue here is the constitutionality of the threatened levy.[5]

3.3.8 A tax is constitutional if it is imposed with the consent of those being taxed or their representatives. Where a tax is levied for the public good it is not predatory if it is imposed for the benefit of those being taxed and largely has the consent of those being levied. In the absence of support for the levy by organisations like Federated Farmers of New Zealand, it would not pass this test.

3.3.9 If one part of the community wants another part to curb its lawful emissions the principle under voluntary exchange is mutual benefit. Emissions would only be reduced if those desiring this outcome were prepared to pay for the costs of achieving it. In the case of greenhouse gas emissions, transactions costs largely preclude such negotiations. In such cases the government may use its power to force an outcome, even in the face of the opposition of those losing their original rights. However, as has long been recognised in the case of takings under the Public Works Act 1981, this action does not remove the principle of mutual benefit or, in practice, full compensation.

3.3.10 The bottom line here is that if this line of inquiry determines that the research is in the interests of the general public rather than mainly in the interests of farmers, as seems plausible, funding from general taxation would be indicated. The same reasoning suggests that the government's current threat is unconstitutional in principle if not in law.

Negotiated greenhouse agreements

3.3.11 It is pleasing that the government has recognised that industries such as steel, cement and aluminium would be adversely affected by measures that will not

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4 *Climate Change: The Government's Preferred Policy Package*, p 31.

5 We stress here that this discussion is concerned with constitutional principles, not with legalities.

apply to major competitors in other countries. Such industries could shift their operations abroad with no benefit in terms of reductions in global emissions. Voluntary agreements with such firms on measures to curb emissions, in line with past policies, are a sensible response in such situations.

3.3.12 However, as in the case of a research levy on agricultural industries, problems arise if voluntary negotiations effectively turn into coercion. In the absence of agreement, Competitiveness-at-risk firms could be faced with a tax on emissions. Moreover, the precise level of this tax cannot be known until 2008, yet the government is already seeking commitments from firms to reduce emissions. Again, a principled approach would require the government to determine whose interests would be served by the threatened tax. If it were in the interests of the public at large, the question of compensation would arise.

3.3.13 The issues raised here have ramifications far beyond the measures contemplated in the discussion document. Indeed, they strike at the heart of the question of sovereign risk and the cost of capital in New Zealand. To the degree that investors perceive New Zealand governments to be behaving in an unprincipled matter in relation to property rights, the cost of capital is raised to the detriment of all New Zealanders.

3.3.14 A further point is that while there may well be valid public policy reasons for tailoring agreements to the situation of particular firms, it is a matter of concern if governments can threaten a firm or individual with a tax if they do not 'negotiate' terms acceptable to the government. Moreover, if the terms can vary from case to case in a non-transparent manner such a system is a recipe for corrupt dealings. It creates a risk that some firms will obtain an advantage over their competitors, including future competitors, through political favours. We submit that the government should give the fullest consideration to providing safeguards against future risks of this sort.

Energy efficiency and renewable energy

3.3.15 The government is banking on the National Energy Efficiency and Conservation Strategy (NEECS) contributing emissions reductions of 20 million tones in the first commitment period. It is clear that this element of the preferred policy package is far from cost-free. To the extent that firms or households are induced by regulations or other measures to alter consumption patterns, economic costs are incurred and national income is sacrificed. A study of the draft NEECS by the New Zealand Institute of Economic Research last year concluded that "the costs to New Zealand of achieving the energy efficiency targets far exceed any potential national or global benefits, with an overall loss to New Zealand in present value terms of between $2 billion and $4.8 billion for the period to 2010".

3.3.16 Similarly, moves to renewable energy are costly, and non-traditional sources of renewable energy are likely to make only a small contribution to emissions reductions in the foreseeable future. There is little evidence that a significant number of consumers are prepared to pay a premium for 'green' energy, hence measures that force them to do so are costly in terms of consumer welfare. For example, last year TrustPower invited customers to pay an extra $2 a week on their power bills to help finance a wind farm. It needed 16,100 customers to justify the investment, but fewer than 200 signed up. Moreover, the project would only have cut New Zealand's CO_2 emissions by 83,500 tonnes a year, compared with the total NEECS target of 15 million tonnes.[6]

3.3.17 The scope for renewable energy is also judged to be limited in other countries. The Californian 800 MW windmill facility at Altamont Pass is to be closed down. Denmark has abandoned any further subsidies. A recent Cato Institute study reported that solar, wind, geothermal and biomass energy are used in about 2 percent of US electricity generation and are expected to produce only 2.8 percent by 2020. It found that:

> Cracking down on greenhouse gas emissions to comply with the Kyoto Protocol would provide economic help for renewable energy technologies, but such initiatives would result in only a 7 percent market share for renewable energy and a 43 percent increase in electricity prices.[7]

A further problem with most forms of renewable energy is that the supply of power is unstable and back-up sources are required to provide security of supply.

3.4 In summary, the main 'low cost' element of the government's proposed policy package for the first commitment period, the use of sink credits, is deeply problematical; both the proposed treatment of sink credits and the measures proposed for agriculture and Competitiveness-at-risk industries raise serious issues of property rights and unconstitutional takings; and the assumed contribution of energy efficiency and renewable energy measures is likely to be costly and based on optimistic scenarios. Moreover, it is scarcely credible for the government to argue that forestry and agriculture will benefit from Kyoto when the weight of opinion in those sectors is strongly opposed to ratification.

The second commitment period and beyond

3.5 The economic consequences for New Zealand of ratification of the Kyoto Protocol are likely to be vastly more severe in the second commitment period and beyond.

3.6 It is a major deficiency of the discussion document and the government's approach that virtually no attention is given to these longer-term implications. The government has openly indicated that it expects Kyoto measures to be intensified over time, given that the present targets for global emission reductions would, even on the assumptions underlying the IPCC's Third Assessment Report, delay any global warming in the twenty-second century by only a few years. Given that the availability of sink credits would be limited after 2012;[8] that the government might have to buy back credits depending on trends in deforestation and changes in land use; that agriculture could not be excluded indefinitely; and that much larger reductions in emissions from Competitiveness-at-risk industries and the transport sector would be required,

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6 'Raising the next generation', *Weekend Herald*, 25–26 May 2002.

7 Jerry Taylor and Peter VanDoren (2002), 'Evaluating the Case for Renewable Energy: Is Government Support Warranted?, *Policy Analysis*, Cato Institute, 10 January.

8 The government acknowledges that "sinks should be seen as a temporary offset, rather than a permanent solution, with fewer sink credits likely to be available in the long term" (discussion document p 14).

the economic costs of ratification to New Zealand in only a decade's time could mount steeply.

3.7 This point can be illustrated by considering the impact of a carbon tax on petrol prices and the General Energy Users sector. The government plays down this impact in the first commitment period, saying that it would not be significant. This is on the basis that a carbon tax of only 6–9 cents a litre at that point is assumed. Such an increase would be minimal in relation to swings in international oil prices and currency fluctuations and would have little impact on fuel consumption. This seems a politically expedient proposal, given that most of New Zealand's increase in emissions since 1990 comes from increased private motor vehicle usage. It is clear, however, that to obtain the reductions in emissions that are likely to be needed to meet (stepped-up) Kyoto targets, far greater increases would be required beyond the first commitment period. A former international oil company executive recently suggested that a 10 percent reduction in petrol consumption would require a doubling of petrol prices, that is, the imposition of a tax some 10 times higher than the government is suggesting for the first commitment period. He commented that:

> To reduce national energy consumption by 10 percent would be a massive task. It will not be made easier … by misleading the public on the sacrifices required to achieve it.[9]

The government calculates that its proposed taxes on petrol and electricity could cost the average household $5 a week. On the basis of the above estimate, the cost could be nearer $50 a week, which would have a dramatic impact on household budgets.

3.8 The consequences of more draconian action for other emitting sectors would be similar. It is implausible to believe that major changes in animal emissions can be achieved within a decade by changes in breeding practices or animal husbandry, thus, stock numbers would have to be reduced. In respect of Competitiveness-at-risk industries, the incentive to shift operations to non-ratifying countries will increase as the second commitment period approaches. If the government continued to shelter particular industries or groups, an even greater cost burden would have to be imposed on others to meet New Zealand's commitments. No amount of revenue recycling would avoid the imposition of massive economic costs.

3.9 The discussion paper is also misleading in not exposing the scale of the administrative apparatus and associated costs involved with the government's plans. These have become clearer following the introduction of the Climate Change Response Bill into parliament. This reveals that a series of extremely prescriptive, and potentially costly, measures are being proposed. The projected Crown (taxpayer) inventory costs alone are put at $4.6 million per annum. The explanatory note to the Bill also points out that "the level of inventory compliance costs under the Bill will depend on the future development of international good practice standards for inventory reporting under the Protocol … Policy measures adopted under the second phase may

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9 Geoff Atkinson, *The Dominion*, 24 May 2002.

also result in increased registry and inventory functions and in related increases in compliance costs".

3.10 The Bill allows for regulations to be promulgated requiring persons to supply information to the inventory agency on any or all of the following:

- emissions of greenhouse gases into the atmosphere;
- volumes of fuel produced, distributed, sold, or used, and the nature of the use of the fuel;
- industrial processes, including by-products from industrial processes;
- composition of vehicle fleets and use of vehicles, including, but not limited to, distances travelled;
- imports and exports of hydrofluorocarbons, perfluorocarbons, and sulphur hexafluoride;
- imports, exports, manufacture, sales, and the nature of the use of products that contain hydrofluorocarbons, perfluorocarbons, and sulphur hexafluoride;
- waste composition and volume of landfill gas extracted and combusted;
- numbers of ruminants and other farmed livestock and their performance;
- areas of crops and amounts produced;
- amount of nitrogenous and lime fertilisers used;
- native and planted trees, the amount of harvesting, the area of land in scrub, and the area of land in other land uses that are necessary to determine land-use change under Article 3.3 or Article 3.4 of the Protocol.

Draconian powers are provided to enable authorised inspectors to enter land or premises at any reasonable time to carry out surveys, inspections, take tests or remove samples. They may also obtain search warrants and enter dwellinghouses to inspect and copy documentation or seize electronic storage equipment. Failure to provide information to the inventory agency will invite a $5,000 fine for an individual or $30,000 for a company.

3.11 This enormous administrative apparatus would impose huge compliance costs in due course on large and small businesses, including farms, despite the government's claim that it wants to reduce the raft of compliance costs that are stifling business activity and to raise New Zealand's growth rate. It lends credence to the view of the *Wall Street Journal Europe*, which recently stated:

> … the truth … is that Kyoto is a monstrosity projected to cost billions, possibly trillions, of dollars to achieve a goal that will probably not avert a threat that no one is sure that the world faces.[10]

3.12 Our assessment of the economic costs of ratification is not called into question by studies such as the New Zealand Business Council for Sustainable Development report *Business Opportunities and Global Climate Change*. While we

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10 *Wall Street Journal Europe*, 6 March 2002.

are sceptical about a number of its assumptions and estimates, it acknowledges that many of the opportunities it identifies are not dependent on the government ratifying Kyoto or the Protocol coming into force. If they are genuine, there is nothing to stop firms taking advantage of them now. To the extent that they are dependent on Kyoto measures, they represent opportunities that arise as a result of distortions to the economy (in much the same way as import licensing and tariffs created opportunities for inefficient domestic production) that would lower national income.

4 Conclusion

4.1 The government's preferred policy package only serves to increase our deep concerns about the implications of ratification of the Kyoto Protocol by New Zealand. In the first commitment period the proposed approach is in the nature of a Clayton's policy. Limited action is proposed, which will be criticised by environmental interests, but at the same time key elements of it are problematical, raise constitutional concerns, and already impose costs. A bureaucratic structure will be established that will no doubt seek to enhance its power and scope. Beyond the first commitment period, the economic costs are potentially enormous. The government is simply not 'coming clean' with the community about the long-term consequences of the course of action it is embarking on. Its drive to ratify seems to embody the worst features of the short-term horizons of politics.

4.2 This conclusion is strengthened by the weak and fallacious arguments for ratification that the government continues to put forward. Its argument that higher energy costs could be offset by a fall in the exchange rate without hurting the economy is simply wrong. The proposition that sink credits are a gain in national income is also wrong – they are a capital account item. The government has presented no evidence in support of its claim that ratification would help New Zealand to capitalise commercially on its clean, green image. In our view it is simply not credible to argue that the world's consumers will buy more New Zealand exports and less Australian or US exports because New Zealand ratifies. The argument that New Zealand will gain technological advantages over the United States and Australia by ratifying seems similarly implausible.

4.3 Any argument that New Zealand has the option of managing future risks by declining to sign up to obligations beyond the first commitment period is scarcely respectable. If the government ratifies it is stating that New Zealand joins in the commitment to implement further measures in subsequent periods. New Zealand should not ratify now if there are sound grounds for believing that the future consequences could be economically devastating and politically unsupportable, as there are.

4.4 Internationally, the entire Kyoto edifice looks increasingly like a unholy alliance between misguided environmentalists and European governments seeking to offset the competitive disadvantages of their low-growth economies by imposing regulatory burdens on others, particularly the United States. The US Senate voted 95–0 against ratification on the proposed terms. Canada's current prevarication over ratification is another indication that imposing economically costly measures to reduce emissions will not be politically sustainable in many countries, given the uncertain scientific evidence about global warming and the minimal environmental benefits of the Protocol. There is widespread agreement that Kyoto would have an inconsequential effect on the climate system.

4.5 We see it as naive for New Zealand, a country that might well benefit from modest warming if it occurs, to be taking a different view. New Zealand's economy cannot easily achieve emissions reductions. We cannot see the case for ratification ahead of the United States and Australia, which are not just major trading partners but also countries with which our international relations are of the highest importance. Average Australian per capita incomes are already around 40 percent higher than New Zealand's. The implementation of the preferred policy package would only serve to widen the gap and work against the government's goal of restoring New Zealand to the top half of the Organisation for Economic Cooperation and Development (OECD) income rankings.

4.6 Furthermore, Kyoto is not the only option open to New Zealand. The possibility that global warming is occurring should be addressed. New Zealand could pursue research and abatement strategies along the lines being developed by the United States and Australia, as well as implement other policies with both economic and environmental benefits, which we have identified in earlier submissions, such as roading reforms and changes to the Resource Management Act 1991. More attention should be given to strategies for adapting to possible temperature increases.

4.7 The government's inability to provide a cogent rationale for its haste to ratify, in conjunction with the risks to which it is exposing New Zealand in the second commitment period and beyond, have all the hallmarks of a major public policy failure in the making. The Think Big projects were arguably New Zealand's last major policy failure – driven through by a government that insisted it knew best. They demonstrate the disastrous economic consequences of political decisions by governments whose interests lead them to look ahead no further than the next election or two.

4.8 The government's National Interest Assessment (NIA) was a document of advocacy rather than analysis that should have been rejected and sent back to officials. We absolutely concur with the minority view in the select committee's report that:

> … vigorously assert[ed] that the NIA should be fully reworked with comprehensive analysis of the costs and benefits of ratification and the fully measured implications of the 'Preferred Policy Package' on the New Zealand economy.

4.9 We believe that the business community is overwhelmingly of the view that in the absence of a sound public policy analysis of such an important issue, and of concerted action by major trading partners, the government should not ratify the Kyoto Protocol. There is no case for urgent action on measures that cannot make a material difference to what might not be a problem. We strongly submit that the government should heed business community views and defer ratification pending a much more competent analysis of New Zealand's interests. This should take into account not just the preferred policy package now put forward but also the longer-term implications of ratification that are ignored in the discussion document.

MASSEY UNIVERSITY PLANNING PROGRAMME

THE RESOURCE MANAGEMENT ACT: FUNDAMENTALLY SOUND OR FUNDAMENTALLY FLAWED?

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PALMERSTON NORTH
19 APRIL 2002

THE RESOURCE MANAGEMENT ACT: FUNDAMENTALLY SOUND OR FUNDAMENTALLY FLAWED?

1 Background

New Zealand's Resource Management Act 1991 (RMA) became law in August 1991. It was in good part a response to dissatisfaction with much existing unwieldy, intrusive and fragmented statute law. It replaced around 25 natural resource and planning statutes and modified or repealed more than 150 other laws and regulations.

In the words of reviewer David Young, the RMA:

> … was an Act that above all else aimed for the holy grail of environmental thinking, a form of sustainability it termed – in the end – "sustainable management" … [1]

The RMA contains definitions of the 'environment' and 'sustainable management' that are so open-ended and inclusive as to allow local governments to regulate comprehensively for social and economic purposes. It is essentially a planning statute. Unfortunately, as with central planning at the national level, such a task raises serious problems of inadequate information and mixed incentives.

Much of New Zealand's history and urban development was not centrally planned. In the nineteenth century, the focus of relevant government regulation reflected a relatively narrow concern with public health and safety, where private arrangements would otherwise be unsatisfactory. This could encompass such matters as flood control, water supply and waste disposal and the density and location of housing.

New Zealand largely escaped planned development through district schemes until the Town and Country Planning Act 1953 came into force in 1954. The presumption that governments were competent to plan economic development was even more evident in the Town and Country Planning Act 1977. This Act allowed governments to direct and control virtually all forms of development.[2]

Dissatisfaction with low economic growth and high unemployment, and the delays to economic development projects caused by planning legislation, led to the National Development Act 1979. This Act sought to 'fast-track' the ill-conceived 'Think Big' projects in the early 1980s.

By the mid-1980s, bureaucrats, business and environmentalists were dissatisfied with the proliferation of 'command and control' legislation. Bureaucrats found it unwieldy, businesses found it mindlessly obstructive and environmentalists believed it was insufficiently protective of 'the environment'.[3] Mike Moore spoke of the need "to remove roadblocks to development".

Yet while the existing legislation had few defenders, there was little willingness to question its fundamental premises seriously. For example, a 1987 review by environ-

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1 David Young (2001), *Values as Law: The History and Efficacy of the Resource Management Act*, Institute of Policy Studies, Wellington, p 2.

2 Grant Scobie and Veronica Jardine (1987), *Town and Country Planning: Toward a Framework for Public Policy*, New Zealand Business Roundtable, Wellington, p 10.

3 Veronica Jacobsen (1999), 'Resource Management in New Zealand: Rhetoric, Reality and Reform', *Agenda*, p 226.

mental lawyer and Queen's Counsel Tony Hearn found that a major official review of the Town and Country Planning Act 1977 had failed to ask:

> What reasons might there be for a specific legislative scheme which supplements or supplants general laws such as the laws of property, contracts and tort which would otherwise regulate decision making in this field?[4]

He strongly recommended that officials establish a relevant policy framework. Another report for the New Zealand Business Roundtable by economists Grant Scobie and Veronica Jardine similarly called for a review of the fundamental framework for legislation and for much greater reliance on market mechanisms supported by the common law.

What happened instead, as chronicled by Young, was that the concept of integrating all relevant Acts into a single piece of legislation was put to the new minister, Geoffrey Palmer, soon after the 1987 election. Palmer's reported reaction was "We're going to do it and we're going to start this afternoon".[5] Young reports senior official Denise Church as saying: "I think Geoffrey Palmer would have liked us to have pulled out the pens and started drafting, not on day one, but about day three. Because for him the end product was legislation ...".[6] The resource management law reform review was given the go-ahead in February 1988 with a view to passing the legislation in the second half of 1989.

All this has a familiar ring to it. Too often in New Zealand's legislative history the imperative has been to enact in haste and repent at leisure, particularly if the task is seen as being to enact a 'world-leading' statute, rather than undertake a careful review of the problem. Far from following, others have preferred to learn from our mistakes.[7] The resource management law reform exercise was arguably the lowest quality regulatory reform initiative of the 1980s Labour government. At no time were a sound framework and set of principles established to guide it.

According to Young, key officials who worked on developing the RMA were influenced by overseas thinking on environmental issues. International confidence in central planning was probably at its height in the 1970s. Important landmarks were the United Nations Conference on Environment and Development in Stockholm in 1972, the (famously wrong) Club of Rome reports that followed the first oil shock, an environment audit of New Zealand in 1980 by a committee from the Organisation for Economic Cooperation and Development (OECD), a 1981 report *Integrating Conservation and Development: A Proposal for a New Zealand Conservation Strategy*, and the 1987 Brundtland report, *Our Common Future*.[8]

Some of those who were opposed to central planning and suspicious of command and control legislation supported the RMA because they thought it would have less of both than the legislation it was replacing. Under this vision, all human development

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4 *Comment on the Review of the Town and Country Planning Act 1977 by A Hearn QC* (1987), New Zealand Business Roundtable, Wellington, p 1.

5 Young, *op cit*, p 18.

6 Young, *op cit*, p 30.

7 New Zealand's accident compensation legislation, in which Geoffrey Palmer also played an important role, is another example of 'world-leading' legislation lacking followers.

8 Young, *op cit*, chapter 2.

would be permitted as long as it did not contravene a district plan, and district plans would be restricted to preserving environmental 'bottom lines'.

The minister who ultimately oversaw the passage of the Bill, Simon Upton, fell into this category. He stated at the time that he saw it as allowing individuals to pursue goals of their own choosing – "what people get up to is their affair" – subject to their compliance with "hard environmental standards" and "a physical bottom line that must not be compromised". Those standards would be set locally when the contents of district plans were determined. He saw the RMA as a liberal departure from the older command and control approach. To him, it was much more permissive, with the aim being to correct for unwanted external effects on the environment.

The Labour government's reviewer of the draft bill, Tony Hearn, took a very different view. He did not see it as an improvement on unsatisfactory existing law. He stated definitively that:

> I simply cannot accept that any reasonable person with a reasonable knowledge of the law and practice of planning and resource management would see the provisions of this Bill as being a better vehicle for carrying New Zealand and New Zealanders into and through the 1990s.
>
> I am firmly convinced … that when the majority of ordinary people understood its effects they would be totally opposed to it.[9]

The Business Roundtable's March 1990 submission on the Bill reported that the business firms it represented were unanimous that it would lead to a "retarded economy, poor environmental decisions and dwindling options for subsequent generations". It argued that the framework of the legislation failed to distinguish adequately between desirable societal outcomes and the appropriate role of government in their achievement.

How does experience with the RMA compare with these assessments?

2 Gains from the RMA – and practical difficulties

Lawyer Alan Dormer conducted a preliminary assessment of the RMA for the Business Roundtable after its first three years.[10] On the positive side, he found that it was faster to get approvals for major projects, in part because of the requirement to prepare environmental impact reports. Other benefits included the availability of non-notification procedures and easier and more effective enforcement.

The key conceptual gain from the RMA was the recognition that it was not the government's role to control directly the use of resources. Instead, local government action should concern itself with regulating 'unpriced' adverse effects of activities on others – in the standard parlance, the RMA is an effects-based statute. Expressed differently, there was a widespread hope that the RMA would be proscriptive about adverse effects but permissive otherwise. As things have turned out, there is

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9 *Submission to the Select Committee of the House of Representatives on the Resource Management Bill* (1990), New Zealand Business Roundtable, Wellington, March, p v.

10 Alan Dormer (1994), *The Resource Management Act 1991: The Transition and Business*, New Zealand Business Roundtable, Wellington.

widespread agreement that local authorities have tended to use the RMA prescriptively.[11]

Another hope was that integrated legislation would facilitate development by allowing a 'one-stop-shop' for developers, saving time and transaction costs. However, costs and delays remain a major concern. Young quotes Denise Church as saying in 1996 that "never in my wildest dreams did I imagine that this legislation would spawn [this huge legal industry]".[12] One of her colleagues, Craig Lawson, saw the RMA as failing to achieve his greatest ambition – that local communities would be able to sort out issues without lawyers and professionals dominating:

> The net result is I don't see less regulation out there and I've seen more myopic, short-sighted command and control than I ever desired to have.[13]

The hope that major projects would get faster approvals from 'one-stop-shop' legislation has been dashed by the ease with which projects become bogged down in objections. The Resource Business Management Forum (RBMF) commented in 1999 that:

> The New Zealand economy is languishing … The RBMF does not consider that the current Act is totally responsible for this but it is a key contributor to the stagnation.[14]

Moreover, Young provides reasons for believing that the hope for integrated management will prove misplaced. Some regions are preparing separate plans for water, air "and so on". In addition, regional councils are failing to find joint solutions to common problems and share the costs. Furthermore, politicians are fragmenting the statute book again by passing legislation that stands outside the RMA but links back to it.[15]

There appears to be near-universal agreement that the problems arise in part from a lack of expertise and a 'command and control' culture in local government. Dormer commented in particular on a lack of economic expertise in undertaking cost-benefit analyses and a lack of experience with, or sympathy for, the use of market instruments. Local authorities have also found it difficult to move from the regulation of activities to the regulation of effects.

To be fair, councils are not to blame for the fuzzy language in the RMA and the problems of trying to administer legislation that requires them to take into account diverse and conflicting objectives with no objective criteria for assessing trade-offs. A 2001 survey by the University of Waikato found that 50 percent of planners in councils thought key provisions in the RMA were unclear.

Dormer praised the Ministry for the Environment for its efforts to assist with these problems. This is not necessarily inconsistent with the views reported by Young that

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11 For example, Young (*op cit*) attributes this view to Joan Allin (p 61), Craig Lawson (p 67) and Sir Geoffrey Palmer (p 67).

12 Young, *op cit*, p 51.

13 Young, *op cit*, p 67 (and p 23).

14 Young, *op cit*, p 68.

15 Young, citing Julie Frieder (pp 48–49) and Royden Somerville (p 59).

central government has failed to provide adequate assistance to local government in administering the Act.

Opinions as to the performance of the Environment Court vary. One criticism is that it has lacked the expertise to detect poor quality economic arguments. Another view is that it is now knocking out some of the worst "fads and ideologies" emanating from local authorities.

Newspapers have documented many cases over the years of absurd decisions and anti-competitive, opportunistic or near-extortionate behaviour resulting from the RMA. A December 2001 report for the Business Roundtable catalogued over two dozen such cases. One supermarket project in Auckland has now been held up for 12 years. The RMA is unquestionably a deterrent to investment in New Zealand and thereby economic development and prosperity. It was identified as a major problem area in last year's ministerial review of business compliance costs.

3 Proposed remedies

The level of dissatisfaction with the resource management law reform exercise has led to almost continuous efforts to remedy its worst features. The National government tinkered with the Resource Management Bill that was still before parliament when it assumed office, but eventually passed it in 1991. Technical amendments were made in 1993. Since then, there has been a series of efforts to make the Act work better.

One proposal is that central government could solve some problems through greater recourse to national policy statements. Young reports that there is a view in the Ministry for the Environment that these provide no panacea: "Everybody loves them until they see them".[16]

In April 1998, Owen McShane produced a report for the government (the McShane Report) from a critical pro-market perspective. This fed into the work of another group, the Ministerial Reference Group, chaired by environmental lawyer Mike Holm.

Many ideas of a practical nature for improving the functioning of the Act, while preserving its structure, emerged from these exercises. They included proposals to:

- set up independent commissioners so as to reduce conflicts of roles;
- allow contestable resource consent processing;
- permit direct referral of applications to the Environment Court;
- provide for more limited notification of resource consents;
- remove 'catch-all' rules in plans;
- change the definitions of 'environment' and 'amenity values';
- provide that proposed plans no longer have effect immediately upon notification;
- allow applicants to reject further information requests; and
- prevent trade competition.

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16 Young, *op cit*, p 41.

The upshot of these efforts were proposals for amendments that reached the select committee stage in the form of a Resource Management Amendment Bill in 1999. The select committee essentially gutted the Bill after the change of government in 1999. It did recommend a number of relatively minor proposals for saving time and costs. It also approved of action to simplify and clarify section 32 and to allow notification decisions to be clarified in the Environment Court. Other recommendations could generally be classed under the categories of strengthening the role for national instruments and the provisions for protecting historic heritage.[17]

The committee reported back to parliament in May 2001, and there the matter lies. In the view of the Business Roundtable, most of the proposals in the Ministerial Reference Group's report and the subsequent Bill have merit and should be implemented.

However, in our view even an RMA amended along these lines would still undermine worthwhile economic development and the rule of law, and work against its own objectives. Local authorities cannot be blamed for a law that they can barely understand and that forces them to make arbitrary decisions for which they are inevitably abused by the disappointed party. The fact that the Act allows competitors and malicious or opportunistic objectors to harass property owners and developers, and thereby exploit the public more generally, is not the fault of local authorities.

People are wont to say that the RMA is fundamentally sound and that the manifest problems with it are a result of incompetent performance on the part of both councils and private sector interests. However, it is always dangerous to assume that people are systematically irrational or incompetent. Whenever dysfunctional behaviour is observed, the question to be asked is what incentives or constraints promote it. In this context, the answer lies in fundamental flaws in the RMA itself.

A more fundamental look at the RMA is required if New Zealand is to move ahead.

4 Fundamental difficulties

The basic problem with central planning is that it assumes a common goal for a community when individuals actually have diverse goals. The authorities then face a dilemma. Either they have to crush those who fail to comply or they must fail to enforce the law and thereby bring it into disrepute. Both results are inimical to economic progress and social cohesion.

Young cites Denise Church as saying in 1996 on her return from six years in Europe:

> I was shocked by the negative attitudes about the RMA, but more shocked by the views that underlay that, that the environment is a cost on business. It was not something that was seen as a strategically valuable asset for New Zealand.[18]

However, legislation that turns an owner's assets into a liability is bound to have this effect. By allowing the denial of compensation for regulatory takings – which alter the value of things people own – the RMA fosters attitudes that conflict with its own purpose.

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17 Young, *op cit*, pp 44–45.

18 Young, *op cit*, p 52. Young attributes similar criticisms of business attitudes in New Zealand to Guy Salmon (p 52) and Julie Frieder (p 50).

The concept of cooperation is fundamental to the common law and civil society. Normally, those who want a right enjoyed by someone else must obtain their agreement to relinquish it, usually by providing compensation in the form of money. The absence of a link between takings and compensation weakens private property rights and therefore the incentive to care for private property. It also discourages voluntary agreements between interested parties.

The RMA undermines the clarity of private property rights by its reliance on fuzzy terms.[19] When people do not know what the law means they do not know what actions are permitted. Judge Adams expressed this concern in 1952 as follows:

> Town planning principles are so vague and uncertain … that a decision based thereon is a bitter pill to swallow … It savours of tyranny where any public authority is invested with a power so vague as this … it is the essence of the 'rule of law' that the rights and duties of citizens be clearly defined, and not left to the discretion of public officials …[20]

The RMA provides little guidance as to how such terms as sustainable management, the needs of future generations, intrinsic values and Treaty of Waitangi principles should be interpreted. Sustainable management sounds fine as a goal – no one is for unsustainable management – but 10 years after the RMA came into effect there have been no judgments that have clarified what it means. Sustainable management is simply not a useful policy construct: it adds nothing to standard concepts of public policy analysis such as public goods and externalities.[21] The concept of intrinsic values poses similar problems. Resource allocations are made by *people* and can only be based on *what people value*. Human welfare must be the criterion for any rational form of decision making, not some value that by definition cannot be discovered.[22]

There are further difficulties with terms such as sustainable management (or development) and intrinsic values. Vague and unquantifiable goals present insuperable barriers to accountability. A council or government agency cannot be held accountable for failing to achieve a meaningless goal. Enormous discretionary

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[19] Section 5 defines the sustainable management purpose of the Act. It uses such terms as enabling "people and their communities to provide for their social, economic and cultural well being", "securing the potential of natural and physical resources (excluding minerals) to meet the reasonably foreseeable needs of future generations", "safeguarding the life-supporting capacity of air, water, soil and ecosystems", and "avoiding, remedying, or mitigating *any* adverse effects of activities on the environment" [emphasis added].

Section 6 specifies five matters of national importance that must be provided. These include the "preservation of the natural character of the coastal environment", the "protection of outstanding natural features and landscapes", and the "relationship of Maori and their culture and traditions".

Section 7 specifies eight matters to which particular regard must be given. These include such terms as Kaitiakitanga – defined as the exercise of guardianship and the ethic of stewardship – "amenity values", "intrinsic values of ecosystems", "heritage values", "quality of the environment" and "any finite characteristics of natural and physical resources".

Finally, section 8 requires that the principles of the Treaty of Waitangi be taken into account.

[20] *Wong v Northcote* 1952, NZLR, 417, as cited by Scobie and Jardine, *op cit*, p 9.

[21] For a discussion of the problematic concept of sustainable development, see Jerry Taylor (1998), 'Sustainable Development: Common Sense or Nonsense on Stilts?', *The Freeman*, September.

[22] For a discussion of the unsatisfactory nature of an intrinsic value conservation ethic, see Peter Hartley (1997), *Conservation Strategies for New Zealand*, New Zealand Business Roundtable, Wellington, pp 147–164.

power is handed to politicians, bureaucrats and those capturing local political processes. Any decision is arbitrary if it conflicts with one criterion but can be justified under another. Other countries have avoided falling into many of these traps. The term 'intrinsic values', for example, does not appear in Australian statute law.

It is unhealthy for legislation to contain unclear concepts. A 1948 English guide to the preparation of legislation commented that nothing was more frustrating for those drafting the law than to have to build a complex structure around 'sacred phrases' that have become sacrosanct because they have been agreed to by Cabinet as part of a political compromise. It noted that the situation often occurs because no agreement has been reached about what those words mean.[23]

In his valedictory speech to parliament, Simon Upton acknowledged that the RMA and other legislation had created great uncertainty and difficulty for ordinary New Zealanders in passing to the courts the responsibility for making political decisions that parliament had been unable to make. He rightly referred to this practice as "legislative evasions" and referred explicitly to references to Treaty of Waitangi principles in this context. The cost to ordinary citizens caught up in these evasions is large.[24]

In 1995 the New Zealand Law Commission identified six common legislative failings. The RMA arguably contains most of them. It defines whatever the real problems are with common law remedies far too widely. It assumes that central planning legislation can succeed yet it is not derived from any framework that supports that proposition. The widespread dissatisfaction with its application in practice indicates that it fails to give effect adequately to the intended policy. Its conferral of what amounts to the power to tax far from the scrutiny of parliament violates the constitutional principle that only parliament should be able to tax. Finally, it fails the test of being understandable and accessible.

The Business Roundtable's submission on the Resource Management Bill concluded that it was fundamentally flawed. Unfortunately, this assessment has stood the test of time only too well.

5 What should be done?

It is impossible to design sound legislation for problems that have been inadequately identified and analysed. University of Chicago law professor Richard Epstein provided an overview to the legal and economic analysis of natural resource law in two lectures given in New Zealand in 1990 and 1999.[25] His discussion covers the problems that information and incentives cause for government ownership, shared government/private ownership and the regulation of private ownership. It highlights the situations in which private ownership regulated by the common law may fail to produce acceptable outcomes.

Economists agree that environmental problems are most likely to occur when resources are over- or under-exploited because of the absence of private property rights. They use the term 'tragedy of the commons' to describe the problems such as

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23 See Bryce Wilkinson (2001), *Constraining Government Regulation*, New Zealand Business Roundtable, Wellington, p 151.

24 *Old Values, New Ideas from ACT Members of Parliament*, 2002, p 79.

25 Richard A Epstein (1999), *Natural Resource Law: Property Rights and Takings*, New Zealand Business Roundtable, Wellington.

over-grazing or species extinction that arise when common ownership allows anyone to exploit a resource, thereby removing any incentive to exercise proper stewardship over it. Under-exploitation or under-preservation can occur when action is blocked because it is too difficult to obtain the consent of all who might object.

Many of our environmental problems result from the common ownership of resources. Private property is crucial for environmental protection.[26] Problems of pests on Crown land and problems with water quality are associated with public ownership. Private owners have a stronger incentive to rid land of pests for commercial or conservation reasons, according to their preferences and objectives.

The Waikato medical officer of health has recently declared that the Waikato river is unsafe around Hamilton because of contamination by sewage or similar material. In a sound common law legal structure, any concerned individual with property bordering the river would have a common law riparian right to take action against local government and other polluters. A recent book illustrates how successfully anglers have used these legal rights in the United Kingdom.[27]

Water quality issues should be a high environmental priority. As minister for the environment, Simon Upton expressed the view that improvements in water quality would take care of "much else of what ails the broader environment".[28] Common law remedies and greater recourse to private ownership and market mechanisms have much to offer in dealing with water management problems.

Where property is in the private domain, the key task is to focus any legislation on addressing problems that are not better addressed by the common law. In the resource management context, a well-argued case that blanket failures in the common law exist and should be addressed by blanket legislation has never been made. Similarly, no case has been made that government land-use planning is superior to private land-use planning.[29]

A fundamental review of legislation governing resource use would start by asking the question: 'What's wrong with the common law?'. For centuries the law of property, contract and tort – with its focus on harms to third parties – regulated development, and great cities were built on this basis. That such a regime is perfectly feasible today is demonstrated by the case of Houston, which has no planning law to speak of. Analyses of the situations in which common law remedies will not be efficacious concentrate on cases of non-point source pollution, such as air pollution from multiple household open fires. Protection of our borders from imported pests and diseases also raises public good issues. So do problems of flood control. None of these require the central planning apparatus of the RMA or its precursors.

In the absence of a fundamental review, there are many interim options for curbing the excesses that have resulted from the RMA. A possible list that goes beyond the mainly procedural and administrative measures listed earlier is as follows:

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26 See, for example, Giuliano d'Auria *et al*, *Property Rights and the Environment*, IEA Studies on the Environment No 13, Institute of Economic Affairs, London, 1999.

27 Roger Bate (2001), *Saving our Streams: The Role of the Anglers' Association in Protecting English and Welsh Rivers*, Research Monograph 53, Institute of Economic Affairs, London.

28 Young, *op cit*, p 87. The words quoted are Young's, not Upton's.

29 For a recent discussion of the case for private land-use planning rather than government planning, see Mark Pennington (2002), *Liberating the Land*, Hobbart Paper 143, Institute of Economic Affairs, London.

1 Increase the right to compensation. This measure would force greater balancing of costs and benefits, promote mutually acceptable agreements among parties, demonstrate greater respect for the victims of the legislation, and avoid turning assets into liabilities.

2 Seek to fund compensation wherever possible from those who claim a benefit from a restriction on development rights. Otherwise taxpayers and ratepayers will be at risk.

3 Limit objections. In particular, competitors and those who are making claims about harms that lack any scientific or objective basis should not be permitted to block the exercise of others' common law property rights. More generally, common law tests of who is an interested party point the way.

4 Restore the rule that the costs of court action can be awarded against litigants.

5 Impose a similar burden of proof on those objecting to a resource use to that which a court would apply to a common law application for an injunction – and seek similar disciplines on the scope of any injunction that is granted.

6 Clarify the law to establish that the only harms and benefits to be considered are those that relate to human welfare. References to intrinsic values would be dropped. So would the extremist notion that there are environmental 'bottom lines' not recognised as common law harms that must be achieved regardless of the cost to human welfare.

7 Eliminate fuzzy language more generally. This applies particularly to the references to Treaty of Waitangi principles and sustainable management.

8 Limit the application of the law to areas in which common law remedies would be likely to be ineffective.

Such a programme could be introduced in a progressive, pragmatic and deliberate manner, or it could be introduced following a major review and standard consultation processes. The latter approach has much to commend it. The community needs to have in front of it a sound policy framework for identifying the actual problems that require government action and the most efficient means of addressing them. The antagonism and animosity that surrounds the RMA today reflects in part the fact that no such framework was established for principled discussion when the Act was being formulated.

The most important message in all this is that the high-quality environment that we all want to see in New Zealand cannot be achieved with legislation that undermines the necessary conditions for achieving that goal – prosperity and well-defined private property rights. Those who share this goal should not feel threatened by an open debate about the best means to achieve it.

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE POST-2005 TARIFF REVIEW

APRIL 2002

SUBMISSION ON THE POST-2005 TARIFF REVIEW

Executive Summary

- The New Zealand Business Roundtable submits that the best way for the government to eliminate uncertainty created by the current tariff freeze would be to announce that the programme of tariff reductions in place prior to the freeze is to resume in 2005.
- As with all policies with economy-wide implications, decisions regarding the future of tariffs should be made with regard to overall New Zealand interests rather than effects on particular regions or sections of the population. Tariffs are a tax on exporters, distort economic activity and reduce potential national income. Tariff reform should be viewed as part of a general strategy to foster more rapid economic growth and to deepen New Zealand's international linkages.
- New Zealand will benefit from removal of its tariff barriers even if other countries do not reciprocate. Tariff reductions should, therefore, not depend on reciprocal actions by other countries. Tariffs undermine New Zealand's international credibility as an opponent of protectionist policies, particularly in agriculture. It is in New Zealand's economic and diplomatic interests to adopt free trade unilaterally.
- Over the last 20 years, reductions in New Zealand's trade barriers have gone a long way toward removing an important impediment to economic growth. This reform needs to be completed to ensure that business decisions are made on the basis of prices that reflect the realities of the international trading environment, to eliminate costs associated with tariff administration and to discourage a waste of resources in lobbying activities.
- Liberalisation has been ongoing for over 20 years, including for the textile, clothing and footwear industries. New Zealand firms have had ample time to plan for the removal of protection, and the remaining adjustments facing some industries are not large by comparison with earlier requirements.
- Remaining tariffs should be removed rapidly to capture the earliest possible benefits of improved resource allocation and efficiency to economic growth. Free trade should be achieved well within the timetable adopted by Asia Pacific Economic Cooperation (APEC) leaders for the removal of tariffs by developed country members by 2010.
- The programme of tariff reductions should give priority to reducing the highest tariffs, since these are generally associated with the greatest distortion of resource use. In the interests of reducing administrative and compliance costs, tariffs should be eliminated when they fall below 5 percent.
- The tariff concession system should become a one-way street. Duty free entry should be allowed if local production of a good ceases and should remain in place until tariffs are eliminated.

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 business firms. The purpose of the NZBR is to contribute to the development of sound policies that advance overall New Zealand interests.

1.2 In announcing this review of tariff policy, the minister of commerce indicated that its purpose is "to give some certainty to business about the future". The NZBR is concerned that the review has potential to add to uncertainty rather than diminish it. The business community at large accepted the programme of tariff reductions that was in place prior to current tariff freeze. The best way for the government to eliminate uncertainty created by the tariff freeze would be to announce that the programme of reductions in tariffs in place prior to the freeze will resume after the freeze ends.

1.3 The views that the NZBR presents in this submission are essentially the same as it presented to the 1998 tariff review. Nothing that has happened in the intervening period warrants any change of view concerning the effects of tariff reductions or the appropriate timing and pace of tariff reductions.

2 Effects of tariff reductions

2.1 It is not possible for decisions made by individual firms to make the best use of resources, consistent with overall New Zealand interests, if those decisions are based on domestic prices that do not reflect the realities of the international trading environment. When governments impose tariffs, what they are doing, in effect, is to send instructions to businesses to respond to a set of prices that differ from those established in international markets. What is the rationale for this? Even the most ardent defenders of tariffs seem to be reluctant to claim these days that the price signals resulting from tariffs are superior to those that would otherwise guide resource allocation. The continued existence of tariffs in New Zealand is merely a legacy of old policy mistakes that should be rectified as soon as possible.

2.2 Trade liberalisation since the mid-1980s has gone a long way toward removing a major distortion and impediment to economic growth in New Zealand. Industries are no longer given almost unlimited government assistance to produce for the small domestic market irrespective of cost, as was the case under import licensing. Firms no longer play the role of mendicants, looking to the government to protect them from international competition instead of seeking ways to improve their international competitiveness. Yet this transformation remains incomplete. Tariffs continue to distort incentives, misallocate resources and reduce per capita income levels.

2.3 As tariffs fall, their adverse effects on the allocation of resources among different industries tend to diminish more than proportionately. This might suggest that when tariffs are low there is not much to be gained from reducing them further. This view is mistaken, however. It ignores the costs of administering the tariff system, including costs to businesses as well as to the government. It also ignores the benefits of a zero benchmark in discouraging rent seeking, the waste of resources in seeking further government assistance. It is much more difficult for those who are tempted to seek tariff assistance to make a case when no other industry has it than to argue that one industry should be granted the same assistance as some other industry.

3 Timing of further tariff reductions

3.1 The NZBR submits that following the end of the tariff freeze all tariffs should be removed rapidly. As tariffs are now relatively low, the adjustments required by industries are not large. Firms would have two years' notice even if all tariffs were removed in 2005. Free trade should be achieved well within the APEC timetable for developed countries established at Bogor.

4 The question of reciprocity

4.1 New Zealand stands to benefit from unilateral tariff reductions, even if other countries do not follow suit. The benefits of unilateral free trade are analogous to the health benefits of giving up smoking. People benefit when they stop smoking unilaterally even when other smokers continue to pollute the atmosphere. Retaining tariffs in New Zealand does not alleviate the problems of New Zealand industries facing tariffs in overseas markets and, because tariffs are a tax on exports, imposes additional costs on them.

4.2 Furthermore, New Zealand does not gain 'negotiating coin' by retaining tariffs. There is no evidence that unilateral liberalisation has cost New Zealand access opportunities in other markets. New Zealand is simply too small for reciprocity to be a consideration in most other countries' policies. A move to full free trade would improve New Zealand's attractiveness as a candidate for free trade agreements with countries like the United States, and would remove irritants in negotiating such agreements, for example, rules of origin requirements. In a World Trade Organisation context, reciprocity hinges on bound tariff rates, not actual rates. Thus, by proceeding with unilateral liberalisation, New Zealand gains the best of both worlds – domestic economic benefits plus recognition for its efforts in subsequent multilateral negotiations.

5 Should a uniform rate of tariff reduction apply to all industries?

5.1 As a general rule, an approach to tariff reductions in which high rates are subject to reductions that are at least proportionate to low rates is desirable in order to give highest priority to reducing the largest price distortions. In the interests of reducing administrative and compliance costs, however, it is desirable to eliminate tariffs in one step when they reach low levels (below 5 percent).

6 What should happen to tariff concessions?

6.1 The NZBR submits that when tariff reductions are resumed the tariff concession system should become a one-way street. If local production of a good ceases, duty free entry should be allowed under existing rules. This will enable firms that use these goods as inputs to obtain them at international prices sooner than would otherwise be possible. In order to reduce uncertainty, however, once goods are subject to duty free entry they should remain subject to duty free entry until the relevant tariffs are eliminated.

7 The broader context of tariff reform

7.1 It is difficult to find anyone these days who is prepared to defend tariffs on the grounds that they are a good way to promote economic growth, equity in income distribution or any other national objective. There is ample evidence that free trade promotes economic and employment growth, including in many regions, and benefits the poorest section of the population. Tariffs, such as those on textiles, clothing and footwear, are regressive – they hurt people on low-incomes most. Arguments are still sometimes advanced that further tariff reductions are undesirable because of claimed adverse effects on some regions or the well-being of some section of the population. However, whether or not particular sectors are affected should not be the decisive factor in determining future tariff policies. When tariff and other policies that have economy-wide implications are decided in the interests of particular regions or groups, this is detrimental to the well-being of the population as a whole. The logic of providing tariffs to benefit particular groups extends easily to suggest, for example, that export subsidies should be provided to benefit other groups, that regulations should be used to protect particular firms from competition, and so forth. An approach to policy making that puts the interests of particular groups ahead of the interests of the general community must inevitably end up stifling economic growth.

7.2 Further tariff reductions should be viewed as one of a range of policy measures required to foster more rapid economic growth and achieve the government's goal of restoring New Zealand to the top half of the Organisation for Economic Cooperation and Development (OECD) income rankings. Adoption of other policies to foster economic growth, for example, reductions in government spending and regulatory reforms, would do a great deal to alleviate problems of adjustment for firms and individuals affected by tariff reductions.

7.3 Further tariff reductions should also be viewed as part of a general strategy to deepen New Zealand's international linkages with other countries, particularly the United States. The potential benefits of such linkages extend far beyond reductions in trade barriers. If New Zealand is clearly committed to reducing trade barriers and following other policies to foster economic growth, it is reasonable to expect that it will be seen as a more desirable candidate for strengthening business and investment linkages than if it is perceived to be looking for a free ride to prosperity by hitching its wagon to a leading economy.

MARLBOROUGH CHAMBER OF COMMERCE

OBSTACLES TO SMALL BUSINESS GROWTH IN NEW ZEALAND

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

BLENHEIM
26 MARCH 2002

OBSTACLES TO SMALL BUSINESS GROWTH IN NEW ZEALAND

The New Zealand Business Roundtable (NZBR) is an organisation comprising mainly chief executives of major business firms. Like its counterparts in Australia and the United States, its structure allows busy people running large organisations to make a contribution to national affairs.

It is emphatically not the case, however, that our concern is to promote the specific interests of so-called 'big business', or even business for its own sake. After all, businesses only exist to meet the interests of consumers, which should come first. The opening up of the economy and the removal of barriers to competition in most markets, which we have strongly supported, have changed New Zealand from a producer-driven economy to a consumer-driven one.

Thus, our mission is about promoting a prosperous economy and fair society to the benefit of all New Zealanders. A healthy, dynamic business sector, generating profits, investment and jobs is fundamental to this goal.

In this context it doesn't matter whether firms are small, large, or medium-sized. What we need are efficient businesses, producing what consumers want at the lowest possible prices.

As a matter of fact, by world standards almost all New Zealand firms are small. And contrary to the claims of anti-globalisation protesters about multinational firms taking over the world, firms in general are not getting larger. As *The Economist* reported some years ago:

> Despite ever-larger and noisier mergers, the biggest change coming over the world of business is that firms are getting smaller. The trend of a century is being reversed. Until the mid-1970s the size of firms everywhere grew: the number of self-employed fell. Ford and General Motors replaced the carriagemaker's atelier; McDonald's, Safeway and W H Smith supplanted the corner shop. No longer. Now it is big firms that are shrinking and small ones that are on the rise.[1]

Moreover, in open markets, businesses – even large ones – have far less power over people's lives than governments and those who administer their regulations, down to the level of the local council officer.

In February 2000 there were about 285,300 enterprises (other than those engaged in agriculture) in New Zealand, employing 1.4 million people. Eighty-seven percent of all enterprises employed up to five people. However, such enterprises accounted for only 24 percent of all employees. On average they employed just 1.4 persons. In contrast, about 1 percent of all enterprises (those employing 50 or more people each) employed 40 percent of all workers.[2] Thus, larger firms employ a lot of people.

We should neither demonise large business nor idolise small ones, or vice versa. Firms in both categories succeed and fail. In 1999 in New Zealand about 44,000 small

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1 *The Economist*, 'The rise and rise of America's small firms', 21 January 1989, pp 71–72.

2 Statistics New Zealand (2001), *Business Activity Statistics 2000*, Statistics New Zealand, Wellington.

firms were established while more than 45,500 were dissolved. There is typically a round of corporate-bashing in New Zealand whenever a large firm fails. However, small firms accounted for 99 percent of all births and deaths of enterprises in 1999. Most firms have a finite lifespan just like human beings. Winding-up is not necessarily a matter of failure or incompetence – a firm may just have been overtaken by new technology or a better competitor – and its closure releases assets that can be put to use elsewhere.

There are some myths about small business. One is that small firms contribute disproportionately to job creation. This may rest on misleading interpretations of the data. Research suggests that survival rates for new and existing jobs increase sharply with employer size. The Organisation for Economic Cooperation and Development (OECD) has recently stated that:

> Firm conclusions cannot yet be made on whether the small firm sector is indeed responsible for a disproportionate share of net job creation. What is clear, however, is that the bulk of new jobs created are in a small number of fast growth firms. These fast-growth companies can be found both in the large and small firm sectors.[3]

It may also be the case that many new jobs are created in small businesses not because that size of firm is particularly able to create new jobs, but because the products for which demand has increased are mainly supplied by small businesses.

Likewise, the belief that small firms are disproportionately innovative may also be a myth. Small firms undertake less research and development than large ones. Large firms are often better placed to exploit the results of innovation, particularly of process innovation. Most small firms do not innovate, do not grow very much, and do not survive long.

The critical issue for public policy is not the size of firms but how businesses of all sizes can make the largest possible contribution to the community's well-being. The Business Roundtable is undertaking a study on obstacles to the growth of businesses in general in New Zealand, but it will focus on problems in the small business sector in particular.

What fosters innovation, wealth creation and economic growth? Politicians and others of an interventionist bent instinctively think of science and research and development. They want to increase the numbers of science and engineering graduates, establish business incubators and pick sunrise industries – biotechnology, information and communications technology and creative industries happen to be the current favourites.

Such instincts are wrong. Of course education and scientific knowledge are important, but they are not the central element in economic growth. The Soviet Union had good education and outstanding scientists but it was an economic basket case. Government-driven innovation is an oxymoron. Rather, it is the entrepreneur who plays the central role in economic growth in a market economy.

Entrepreneurs are enterprising individuals, often without higher educational qualifications, who identify opportunities and take risks to test their hunches. They

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3 Organisation for Economic Cooperation and Development (1998), *Fostering Entrepreneurship*, OECD, Paris, p 47.

start new businesses, expand existing firms and close down unprofitable ones. Within firms they introduce new products, improve existing products and reduce costs by adopting new production techniques and economising on inputs. Entrepreneurs accelerate the generation, dissemination and application of innovative ideas. Through such activities, resources are put to more efficient uses, the economy becomes more productive and wealth is created.

It follows that the key requirement for innovation and economic growth is to make it easy for entrepreneurs to perform their vital role. You can see this by looking at Silicon Valley, arguably the world's foremost crucible of innovation in recent decades. Silicon Valley was not 'made in Washington' except in the sense that it is relatively unburdened by taxes and regulations, although both remain a threat to its vitality. Rather, it is due to a free-wheeling entrepreneurial culture, capital markets that facilitate investor risk taking and labour markets that facilitate both hiring and firing. Such an environment encourages start-ups, competition forces continuing innovation, and investors are able to cut their losses readily if plans don't work out.

Obviously there will be less entrepreneurship if obstacles are put in the way of entrepreneurs. Obstacles can be created both by social attitudes and government policies. Hence the entrepreneur's response 'leave us alone' to the question: 'I'm from the government. How can I help you?'.

Supportive cultural attitudes are important. An environment in which entrepreneurship is valued by society, and in which shame does not attach to business failure (in the absence of wrongdoing or gross incompetence) will be more conducive to entrepreneurship. Entrepreneurs are not as highly valued in New Zealand as in the United States and many Asian countries. Much of the school system seems to reflect an anti-business bias despite the fact that the majority of school children will ultimately be employed in the private sector. Successful people tend to be pulled down. High incomes generate envy. There is still a strong habit of looking to the government for solutions to problems. All these things hold back enterprise and wealth creation.

The main policy barriers to business growth are taxes and regulations.

Taxes in New Zealand are high by historical standards and relative to those of more successful countries. Any moderately successful business person faces a combined rate of tax approaching 50 percent, having regard to a 39 percent income tax, goods and services (GST) of 12.5 percent and accident compensation and other levies. They spend half the year working for the government. This tax burden in turn reflects spending by governments at all levels equal to around 40 percent of gross domestic product (GDP), which is far higher than historical levels and well above that of countries such as the United States, Ireland, Australia and many Asian countries. No country has achieved the growth rate targeted by the government with that amount of lead in the saddlebags.

Taxes are also the main source of business compliance costs. The costs of complying with tax have been estimated to be around 2.5 percent of GDP, or as much as the government spends on defence and law and order. The cost for the median farmer was estimated to be $3,220 in a 1998 study. The government's decision to increase the top tax rate to 39 percent complicated the tax system greatly and required 47 pages of new legislation. Proposals to cut the company tax rate without cutting personal rates would make the situation even worse. Tax simplification exercises are largely futile unless basic issues of tax structure are addressed. New Zealand needs a lower and flatter tax structure, as advocated by the McLeod Tax Review.

Regulatory barriers to enterprise in New Zealand are also high and rising. Some were removed with deregulation initiatives in the late 1980s and early 1990s, but since then the regulatory creep has resumed. The 1990s saw the enactment of the Resource Management Act 1991, the Human Rights Act 1993, the Privacy Act 1993, the Hazardous Substances and New Organisms Act 1996 among others, as well as much judge-made employment law. Between 1997 and 1999 a total of 376 public Acts and 1276 statutory regulations were adopted.

In the last two years the regulatory creep has turned into a gallop with a tariff freeze, the removal of competition in accident insurance, the re-regulation of the labour market, energy efficiency regulation, further controls on company takeovers, a more restrictive Commerce Act, greater regulation of electricity, gas and telecommunications, together with plans to extend regulation of health and safety, expand the Holidays Act 1981, ratify the Kyoto Protocol, and much else.

All of this will have added over $26,000 dollars a year to the costs of a medium-sized business by the end of this parliamentary term, according to Business New Zealand. The efforts of recent governments to rein in compliance costs have been unsuccessful. Who remembers the business compliance cost reduction programme initiated by Bill Birch and Wyatt Creech in 1994 or the 1998 parliamentary inquiry into compliance costs? The 2001 Ministerial Panel on Business Compliance Costs established by minister of commerce Paul Swain has turned out to be equally forgettable.

Some studies have concluded that regulatory barriers to entrepreneurship in New Zealand are lower than in some other countries. We have advantages such as low barriers to competition and it is easy to register a company. However, within the OECD area countries like the United States, United Kingdom, Canada, Australia and Ireland typically rank ahead of New Zealand in other areas. Even under the 1991 Employment Contracts Act New Zealand ranked after all these countries apart from Australia for the ease of hiring and dismissal of workers. With the Employment Relations Act 2000 that ranking may have slipped.

Sometimes, people say that regulations and the cost of complying with them hit small businesses harder than large businesses that have resources and systems for complying with them. However, that's not the full story. Some of the costs incurred by large businesses in setting up compliance functions and board audit and compliance committees are huge. Directors cannot afford not to take them seriously. On the other hand, small businesses cannot hope to meet the requirements of all the regulations they are supposed to cope with, so many are ignored. A compiler of a business compliance manual noted a year or two ago that over 60 pieces of legislation affect the day-to-day running of every business. While ignoring the law saves costs, it brings the law into disrepute and puts firms at risk.

Just as with tax, New Zealand cannot afford regulatory lead in its saddlebags. It has to strive for the best possible regulatory environment if we are serious about economic growth and higher incomes. Moreover, it needs to adopt superior policies and institutions to help compensate for its twin disadvantages of size and location. New Zealand's small size limits the scope for competition in respect of non-traded goods and services. The distance from large markets also constrains competition.

What should be done to create a better environment for businesses of all sizes in New Zealand? The answer is not to leave all the undergrowth in place and then hope that an 'active' government will occasionally hack a path through it, as it did to obtain resource consents for a boatbuilding firm. Nor is it to hope that a 'smart' government will pick business winners with taxpayers' money – think how clever it would have been to bribe Motorola to set up in New Zealand just when the world market for its products was about to collapse.

Rather, governments should concentrate on their core tasks of creating sound institutions and policies and then get out of the way. We don't need them running businesses or providing venture capital and export credit insurance. Instead, we need well-defined property rights, enforcement of contracts and limited government. As one study has put it:

> Secure property rights and low taxes will encourage individuals to engage more intensively in productive activity. Greater freedom of exchange will expand the realization of gains derived from specialization and economies of scale. Freedom to enter and compete in markets will help both to promote efficiency in production and to direct resources toward their most highly valued uses. Furthermore, entrepreneurial discovery of new and improved technologies, better methods of production and opportunities that were previously overlooked is an important source of economic growth. Economic freedom facilitates this process and thereby promotes growth.[4]

For several years the trend in policies has been to make the environment for business in New Zealand harder, not easier. Higher government spending and regulation have taken their toll. The economy averaged around 4 percent annual growth in the five years to 1996 and 3 percent for the decade of the 1990s as a whole. This was a far better performance than in the preceding decades, but we have lost ground again. Present policies fall far short of what is needed to achieve the government's goal of restoring New Zealand to the top half of the OECD income rankings. Indeed, their effects are likely to show up in the form of a further deterioration in performance in the next few years.

A recent study for the Small Business Survival Committee in the United States outlined a programme to improve that country's economic outlook.[5] It called for lower income taxes with the ultimate goal of a single flat rate; a massive deregulation effort including a system to help prevent the imposition of wrongheaded new regulations; reductions in the size of government at all levels; and the removal of barriers to trade. The study stressed that the total size of governments matters most. The message to all political parties from small and large businesses in New Zealand should be the same. No other approach will make much difference.

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4 Gwartney, James D, Lawson, Robert A and Holcombe, Randall G (1999), 'Economic Freedom and the Environment for Economic Growth', *Journal of Institutional and Theoretical Economics*, Vol 155 (4), pp 646–647.

5 Raymond J Keating (2001), *Understanding Supply-side Economics: The Principles, the Policies and the Future*, Small Business Survival Committee, Washington.

EXPORT INSTITUTE

BUSINESS, TRADE AND THE ENVIRONMENT

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

WELLINGTON
12 FEBRUARY 2002

BUSINESS, TRADE AND THE ENVIRONMENT

With reasonable surety one can expect that the material conditions of life will continue to get better for most people, in most countries, most of the time, indefinitely. Within a century or two, all nations and most of humanity will be at or above today's Western living standards.[1]

These are the opening words of the last chapter of *Hoodwinking the Nation*, the last book of Julian Simon, the scholar who, more than anyone else, demonstrated what was wrong about so many of the environmental beliefs of our time.

Simon was influential with policy makers but was largely ignored by the popular media and vilified by the environmental movement as a tool of Big Business. Yet the new book *The Skeptical Environmentalist* by Danish academic Bjorn Lomborg, which has been getting worldwide reviews, essentially argues that Simon was correct. Lomborg once held what he calls "left-wing Greenpeace views". His book may turn out to be the most influential report on the environment ever written. It is an unfortunate mark of New Zealand's insularity that, with few exceptions, New Zealand newspapers have not covered it. The Ministry for the Environment, which has become much more an advocacy body than an impartial adviser to governments, has shown no interest in bringing Lomborg to New Zealand.

In this talk I want to make four main points.

1 The prophets of doom have a dismal record

This is the main conclusion of Simon and Lomborg. The crisis virus goes back centuries. The shortage of wood in seventeenth century England was expected to cripple the navy and make home heating unaffordable. The Reverend Thomas Malthus warned that population growth made starvation inevitable and imminent. The economist Stanley Jevons predicted in 1865 that Britain was about to run out of coal, and in 1914 the US Bureau of Mines predicted that American oil reserves would last only 10 years.

In the modern era, starting with the notorious Club of Rome report of 1972, there have been four big environmental fears:

- Natural resources are running out.
- The population is ever growing, leaving less and less to eat.
- Species are becoming extinct in vast numbers; forests are disappearing and fish stocks are collapsing.
- The planet's air and water are becoming more and more polluted.

As Simon, Lomborg and many others have demonstrated, the evidence does not back up this simplistic litany. Energy and other natural resources are becoming more abundant; the population is already trending downwards in the developed world; world food output is greater than ever; the risk of species loss has been grossly exaggerated; and most forms of pollution have diminished in the advanced countries

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1 Julian Simon (1999), *Hoodwinking the Nation*, Transactions Publishers, New Brunswick, p 123.

and typically reduce as countries grow richer – beyond a per capita income threshold that appears to be around US$5,000.[2]

This is not to argue that there have been no genuine environmental scares or that none are in prospect in the coming century. We cannot possibly know what they will be – nuclear energy and cloning were unheard of a hundred years ago. But there are systematic reasons for the generally improving trends, and scientific knowledge continues to advance apace. As *The Economist* argued in a 1997 article:

> … predictions of ecological doom, including recent ones, have such a terrible track record that people should take them with pinches of salt instead of lapping them up with relish.[3]

Even worse, they distract attention from real environmental and economic issues.

2 Economic growth and environmental improvement typically go hand-in-hand

It is extraordinary that so many Greens remain anti-growth. Poverty is the greatest barrier to environmental improvement. Truly poor people cannot afford 'luxuries' like clean air and water; to survive they must exploit any available source of food and energy. Forcing environmental (and labour) standards down people's throats does nothing to elevate them out of poverty.

Market-oriented economic growth is the best friend of the environment. Richer countries adopt cleaner technologies, build better infrastructure and can afford the trade-offs between development and the environment where they occur. By contrast, centrally planned economic systems are environmental disasters: they entrench poverty and are callous about environmental degradation. Authoritarian governments can afford to turn a blind eye to pollution in a way that democracies sooner or later cannot.

Well-functioning markets economise on resources that become scarcer: prices rise, encouraging both conservation and the search for substitutes. Competition also spurs continuous discovery and innovation. Since 1977, the gross domestic product of the United States has doubled and its population has grown by some 55 million people yet the amount of physical material needed to supply the annual wants and needs of Americans has fallen from 1.18 trillion pounds to 1.08 trillion pounds.[4] People create resources that replace less valuable ones: the Stone Age didn't end because humanity ran out of stones. Lomborg is confident that cheapening solar power will make fossil fuels and their emissions redundant long before they run out or cause damaging global warming. Environmentalists can't be worried about both global warming and the depletion of fossil fuels: something has to give.

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2 Air pollution in London peaked around 1890. Today London's air is cleaner than it has been since 1585. The number of 'bad air days' in major US cities dropped by two-thirds between 1988 and 1997. Even in Mexico City the air is now cleaner than in Los Angeles 30 years ago. In New York City in 1900 horses deposited 2.5 million pounds of manure and 60,000 gallons of urine every day. Every year the authorities had to remove an average of 15,000 dead horses from the streets.

3 *The Economist*, 20 December 1997, p 19.

4 Ronald Bailey, 'Dematerializing the Economy', *Reason Magazine*, http://www.reason.com/rb/rb090501.html.

In many countries, including New Zealand, governments are still not exploiting approaches that are win-win from both an economic and an environmental viewpoint. The use of roads is often underpriced, adding to congestion. Markets for common property resources such as water are not created, leading to wasteful use. Efficiency and innovation are sacrificed by keeping industries in government control. Central planning approaches are applied to the management of conservation estates and biodiversity with predictable results. Regulation is needed to deal with some environmental problems, but far more scope exists to harness the power of private property rights, markets, prices and the rule of law for both economic and environmental gains.

3 Trade and environmental agreements should be kept apart

Openness to trade and investment promotes development and higher incomes, which enable developing countries to make environmental gains. Trade liberalisation seeks to reduce subsidies that are often the worst cause of environmental degradation. Nations with low environmental standards tend to attract far less foreign direct investment than those with high standards.[5] Globalisation encourages a race, not to the bottom, but toward the top. The World Bank recently concluded after six years of study that so-called 'pollution havens' – developing countries that provide a permanent home for dirty industries – have failed to materialise. Anti-globalisation environmentalists are once again on the wrong side of the argument: the evidence shows that free trade is good for the environment.

Environmental problems are predominantly local – not even national – in nature. Few call for multilateral action. Multilateral environmental agreements (MEAs) have a place for problems of a global nature such as cross-border pollution, ozone-damaging fluorocarbons and international trade in endangered species (although the focus of the Convention on International Trade in Engendered Species (CITES) on trade is too narrow). Some of them, however, have been poorly conceived, for example the Basel convention on hazardous wastes, and others have made insufficient use of market mechanisms. Moreover, there is no case for industrialised countries seeking to impose their own environmental standards on poorer countries through MEAs or trade agreements. Such action would be a violation of sovereignty: their own governments are best placed to determine the trade-offs appropriate for their economies' level of development.

The MEAs typically contain their own monitoring and enforcement standards. This is as it should be. Contrary to the position of the European Union (EU) in the lead-up to the World Trade Organisation (WTO) meeting in Doha, there is no need for 'clarification' of the relationship between WTO and MEA rules to be a matter for negotiation. This is a 'make believe' problem. Still less is there a case for trade sanctions for breaches – these would be a poison pill for a new WTO round.

Equally, the EU's attachment to the so-called 'precautionary principle' is misplaced. This 'principle' adds nothing to well-established risk analysis techniques. Practically everything societies use – food, water, fire, electricity, cars – poses some risk of harm to humans or the environment. The precautionary principle adds nothing to the standard case for basing public and private decisions on valid scientific evidence. It ignores the very real dangers to humans and the environment of blocking

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5 See Daniel Griswold, 'Trade, Labor and the Environment: How Blue and Green Sanctions Threaten Higher Standards', Cato Institute, August 2001.

technological advances such as genetic modification. Developing countries are right to be suspicious that the motivations for WTO initiatives of this type are not the new concern for higher standards but the old desire for protectionism. As Victoria Curzon Price, an eminent trade authority, has put it in arguing against including social and environmental clauses in the WTO framework:

> The law as it stands is consistent and needs, as far as I can see, no major modification. To the extent that public opinion in the rich, developed world keeps up the pressure 'to do something', this should be channelled into voluntary labelling of products, private boycotts and shareholder activism by the socially conscious. All the WTO needs to do is to continue the constant battle for more open markets.[6]

4 Business should 'do the right thing'

No business person I know disputes that businesses have social responsibilities, which include responsibilities for the environment. Corporations have been affirming such responsibilities in their mission statements for years. Businesses and business organisations that have defended the institutions of the market economy and the case for rigorous scientific evaluation of environmental issues have been on the right side of the environmental debates of the past 30 years. They have no need to cede the moral high ground to their critics.

To the contrary, the danger for business and for society at large is to stay silent in the face of bogus environmentalism and seek to appease critics by engaging in false notions of corporate responsibility. Patrick Moore, the former head of Greenpeace who has since dissociated himself from it, has rightly said that most of the major environmental battles are now won in the developed world and that many environmental movements are looking for funding by drumming up imaginary problems. Australian Bureau of Statistics surveys have found that Australians are becoming less worried about the environment, not more. If Bjorn Lomborg can say that "Global warming is not anywhere near the most important problem facing the world", business people should surely have the courage to do likewise. It makes no sense for New Zealand to ratify the Kyoto Protocol in advance of action by our main trading partners and other major emitters, and in the absence of sound analysis showing that it would be in New Zealand's interests to do so. Arguments advanced to date by the government, such as the proposition that New Zealand could avoid the economic costs of higher energy prices by devaluing, are simply incorrect.

Businesses can certainly work with non-governmental organisations in pursuing environmental goals, but in a discriminating way. Greenpeace has done some good work but it is also notorious for peddling lies and false statistics – Patrick Moore has written that "Greenpeace policy on genetics lacks any respect for logic or science".[7] Greenpeace has also engaged in misguided campaigns such as its successful attempt to force Shell to dispose of its Brent Spar oil platform on land rather than at sea, an outcome that brought both higher economic costs and greater environmental damage. Such campaigns should be resisted not appeased: the World Business Council for

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6 Victoria Curzon Price, 'Right and Wrong Ways of Addressing Labour Standards and Environmental Concerns', in *Reason Versus Emotion: Requirements for a Successful WTO Round*, www.rirdc.gov.au/pub/cat/contents.html.

7 See http://www.greenspirit.com, 15 October 2001.

Sustainable Development did world business a disservice by not speaking out over the Brent Spar episode.

A new concept of Corporate Social Responsibility (CSR) has been promoted in some quarters, partly in response to hostile critics of corporations but with support from sections of the international business community as well as outside commentators. It holds that businesses should embrace 'corporate citizenship'. They should run their affairs, in conjunction with a range of 'stakeholders', so as to pursue 'sustainable development'. Meeting 'society's expectations' in this way is said to hold the key to public support for businesses and to long-term profitability.

Former OECD official David Henderson has criticised this development in his book *Misguided Virtue: False Notions of Corporate Social Responsibility*.[8] He points out that concepts such as 'sustainable development' are neither well defined nor agreed; that CSR accepts a false view of the market economy and globalisation; and that making profits in a competitive market means doing the right thing by 'society', not just (as is often thought) benefiting shareholders to the exclusion of other 'stakeholders'. Profits are the difference between a firm's revenues (the value people place on what it produces) and the costs of meeting people's needs. Hence, profits are the prima facie measure of the good that a business is doing for people in general.

Former *Australian Financial Review* editor Alan Kohler has also cautioned against the triple bottom line thesis, which "has become an excellent tool for expanding the size of corporate PR departments across Australia". Lomborg's book, Kohler writes:

> … should sound an alarm for those companies rushing towards uncritical acceptance of triple bottom line reporting. All businesses should obviously minimise the mess (pollution) they make, but that does not mean accepting all the nonsense talked by environmentalists, which simply burdens the world with unnecessary costs.[9]

Journalists should be far more sceptical about claims of corporate virtue. Enron is just the latest 'triple bottom line' company that has come to grief. An internal memo reveals that it lobbied self-servingly for the Kyoto global warming treaty on the grounds that it would "do more to promote Enron's business than almost any other regulatory initiative". Fletcher Challenge was a company that climbed on the sustainable development bandwagon but gave far too little attention to its first bottom line – the duty to create, not destroy, shareholder value. The triple bottom line concept lacks a meaningful foundation. Companies should have other bottom lines beyond profit but they don't stop at three – they should have an ethical bottom line, for example. It seems Enron had several bottom lines missing.

To sum up: to be on the side of business, the market economy and economic development is not to be against people and the environment. Both the wealth created by business and environmental amenities are part of the quality of life. Environmental claims need to be rigorously assessed: too often in the past they have turned out to be unfounded. Science should not be displaced by superstition. Economic and environmental progress go together – richer is typically cleaner – and market-oriented approaches promote both. Policy responses to environmental problems are best

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8 David Henderson (2001), *Misguided Virtue: False Notions of Corporate Social Responsibility*, New Zealand Business Roundtable, Wellington.

9 Alan Kohler, 'Environmental costs scrutinised', *Australian Financial Review*, 14 August 2001.

assessed using the conventional tools of public policy analysis, particularly the concepts of property rights, transactions costs, public goods and externalities, which are the subject of a large and rigorous literature. The concept of sustainable development seems more a slogan than a useful policy construct.[10] Where there are genuinely global environmental problems, these should be dealt with through sound multilateral environmental agreements – they should not get tangled up with trade negotiations.

Finally, the business world needs to examine closely its contribution to public debate on these issues. Businesses and business organisations should stand up for the truth as they see it, and not yield to threats or hostile actions on the part of anti-business activists or opponents of the market economy. Every failure in this respect by individual corporations makes it harder for the rest. Appeasement of radical critics, or even endorsement of their views and aims, might look like prudent conduct and good public relations. But it is not responsible behaviour, and it goes against the true interests of both businesses and society as a whole.

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10 See Jerry Taylor (1998), 'Sustainable Development: Common Sense or Nonsense on Stilts?', *The Freeman*.

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE POST-WINTER REVIEW OF THE ELECTRICITY SYSTEM

OCTOBER 2001

POST-WINTER REVIEW OF THE ELECTRICITY SYSTEM

Executive Summary

- This submission on the minister of energy's post-winter review of the electricity system 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.
- We have publicly commended the minister for his handling of the winter electricity shortage. Although the government inherited an imperfect market, it was wise to reject calls for further ill-conceived interventions at a time of market disruption. The market handled the shortage better than during the electricity crisis of 1991.
- Nevertheless, we see grounds for serious concern about future private sector investment in the electricity industry. The continuing trend towards altering incumbents' property rights without compensation and impediments to new investment under the Resource Management Act 1991 make for an increasingly hostile environment for investment.
- In our view, the high level of government ownership of the electricity industry combined with overly intrusive regulation create high risks of a repetition of this winter's events.
- These concerns also apply to the previous government's decisions affecting the sector and are not a simple matter of blaming government. There will always be pressures for greater intervention from self-interested parties and those with naive views about competition and market behaviour, as long as politicians are receptive to them.
- There have been significant improvements to the electricity system, and suppliers and users have learned lessons from the recent shortage that will help avoid further mistakes. There is now time for careful analysis of the scope for further improvements.
- This should be conducted in a rigorous manner free from political constraints. In our view, the most serious outstanding problem is the extent of state domination of the industry, which restricts its development and impairs market competition. State domination has increased as a result of recent events. With electricity being predominantly a private sector industry around the world and with ongoing moves in this direction, the government should not set its face against privatisation on ideological grounds.
- Although we regard the government's plans on climate change as precipitate, the improvements in energy efficiency that could be obtained from a private, competitive industry could far outweigh the gains from the more interventionist and costly measures that the government is contemplating.
- Any proposed changes to electricity industry regulation arising from the review should be shown to meet the requirements of Regulatory Impact Statements (RISs). For the RIS process to have credibility, options for increasing competition through reductions in state control of the industry must be considered.

1 Introduction

1.1 This submission on the minister of energy's post-winter review of the electricity system 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 review is to consider whether further changes are required to New Zealand's electricity market arrangements. The minister has stated that a number of electricity consumers and industry participants are asking whether the market worked properly under dry-year supply pressure.

1.3 In September we publicly commended the government for its handling of the winter electricity shortage, in particular for resisting ill-considered calls for price controls, profit rebates and other interventions. We agree that it is timely for careful reflection as to the lessons to be drawn from this experience.

2 Weaknesses in current arrangements

2.1 In our view there are important weaknesses in current arrangements, particularly when taken as a whole. The most serious one is the extent of government ownership of the industry but they also include aspects of regulation.

2.2 *Government ownership* Government ownership creates the following difficulties:

- conflicts of interest for the Crown;
- lack of accountability as a result of mixed objectives for the state-owned enterprises (SOEs) themselves;
- politicisation of pricing and investment decisions; and
- heightened risks for private sector participants.

2.3 Government ownership creates a conflict of interest for the government over policies that could benefit its own companies relative to competitors and consumers. Its interest in obtaining votes from household consumers, who have more voting power than non-residential users, influences its attitude towards the pricing decisions of SOEs and puts taxpayers at risk. Other political parties exert pressure for non-commercial interventions, as occurred during the crisis when there were calls for SOEs (but not private generators) to rebate 'windfall' profits.

2.4 The same issue arises at the level of SOE boards. Ministers appoint the boards of the SOEs. This exposes them to similar conflicts of interest because they are inevitably sensitive to political considerations to a greater or lesser extent.

2.5 The presence of conflicting objectives makes it difficult for SOEs to price risks commercially. For example, suppose an SOE sells a hedge contract to a competing retailer. How is the board (or the retailer) to know that the same SOE will not undercut it in the event that there is no power crisis by underpricing the risk to its own retail customers?

2.6 During the recent shortage, the SOEs had the option of passing on the higher wholesale market prices to households, as OnEnergy attempted to do. In the event the use of the price mechanism as a means of rationing a scarce resource was largely suppressed in this part of the market. This also precipitated the renationalisation of OnEnergy's retail electricity business.

2.7 Since the alternative to rationing by price is to ration by quantity, the limitation of the price response to non-residential customers also forced the government to call more vigorously for voluntary rationing. Voluntary quantity rationing rewards those who use power wastefully. This is inefficient and inequitable. Forced quantity rationing is an even less attractive option.

2.8 Why were prices to households not raised during the shortage? At this stage answers to this question are necessarily speculative and should be examined by the review. One reason that has been suggested, namely that generators could not justify higher prices because their costs had not risen, is political. It has no basis in economics or commerce. It confuses accounting cost with opportunity cost. Market prices are not determined by production costs but by supply and demand. Sometimes market competition may force firms to sell below cost; on other occasions they will be able to sell above cost. This reflects the operation of normal market processes.

2.9 An alternative argument is that the SOEs did not raise retail prices because they wanted to force competitors such as OnEnergy out of business. This might be a valid commercial strategy or an anti-competitive manoeuvre. Neither of these explanations is particularly plausible in the absence of collusion between SOEs or other special circumstances. Moreover, no individual SOE could be sure of picking up the customers of a failed retailer cheaply, given competitive bidding.

2.10 Nevertheless, the possibility or suspicion of predatory behaviour underwritten by taxpayers must act as a deterrent to private sector investment in the electricity industry. Even if the problem is more one of perception than of reality, it cannot be eliminated as long as Crown ownership persists.

2.11 A further possibility is that the SOEs did not want to lose retail customer goodwill. This is undoubtedly a valid commercial consideration. The accountability issue arises because it is unclear whether such a reason explains the pricing outcomes – as might be assumed in an industry made up of private firms – or whether other factors were at work.

2.12 An unrelated commercial argument is that one or more SOEs may not have raised the retail price because they did not effectively control it. This might be because of hedge contracts. If a generator has already used such contracts to sell power forward at a given price, the rights to resell that power at a higher price might lie elsewhere. The question then becomes why resellers did not respond to opportunity cost considerations and raise prices.

2.13 The lack of response of retail prices during the shortage would not be a concern if it reflected an explicit fixed or capped pricing agreement with household users. Under such a contract the risks of shortages would lie with suppliers (unless they shifted the risks through hedge or other contracts) and the costs of this form of insurance would normally be charged to retail users. The last point is critical. If household bills do not include the costs of this insurance cover, they must be being borne in some proportion by other users or by investors at the expense of allocative and dynamic efficiency respectively.

2.14 Talk of paying households to conserve power during the winter shortage suggests that current household bills include an insurance premium element. In a more normal competitive market, it might be expected that households would be offered a range of insurance contracts so as to allow them to self-select, at least to some degree, their exposure to risk during shortages. Those taking more risk would get their power more cheaply on average. Obviously, concerns about credit risk would influence the terms of the contracts offered.

2.15 The main point we draw from these speculative remarks is that the fact of government ownership makes it difficult to assess whether the electricity market is operating efficiently and to hold SOEs accountable for their pricing decisions. It may be impossible to unravel the relative importance of political and commercial considerations in any decision. This creates risks for purely commercial competitors. Because electricity is a private good and generation is a competitive activity, there is no justification for government ownership of its production. The risks for taxpayers can only be compounded when the Crown owns multiple generating companies that compete with each other when bidding to buy assets.

2.16 Finally, Crown ownership of Transpower exacerbates the threat to dynamic and allocative efficiency for the same reasons. Decisions by Transpower have the potential to affect generation decisions materially. Distributed generation can substitute for transmission services but we understand Transpower contracts exclusively with line companies to the disadvantage of small generators. Grid constraints appear to be causing unjustifiable price differentials at nodes that are geographically closely located. We consider that these are issues that should be examined in the review.

2.17 *Other forms of government regulation* The previous government's separation of lines from energy is now widely condemned. It was not supported by a competent regulatory impact analysis, as required at the time by Cabinet Office Circular CO(98)20. We criticised it as an uncompensated regulatory taking of which the likely effect would be to reduce private sector willingness to invest in New Zealand network industries. The enormous industry restructuring forced by this 'heavy-handed' regulation contributed to the subsequent problems of inadequate customer service and the difficulties for companies of balancing supply and customer demand. There are important efficiency reasons for vertical integration in the electricity industry. The electricity review conducted last year by the Hon David Caygill recommended some relaxation of the prohibition on generators owning line companies. An issue for the current review should be whether greater integration should be permitted, subject to normal competition law.

2.18 The use of optimised deprival values (ODV) as a de facto form of price control in the electricity industry is another regulatory concern. Rate of return regulation can easily result in cost-plus behaviour (a loss of productive efficiency). To the extent that it has the effect of letting losses lie with the producer while capping profits to the required rate of return, it can be expected to deter investment in future production.

2.19 Environmental regulation already represents a serious threat to future private investment in generating capacity. The delays in getting consents under the Resource Management Act 1991 obviously reduce flexibility in the industry and deter investment. The overriding of the common law definitions of an interested party and of a harm has created a 'tragedy of the anti-commons' situation.[1] Side-effects include competitors using the Act for anti-competitive purposes and extortionate demands from opportunistic objectors with no common law interest. The review should look closely at features of the Resource Management Act 1991 that pose risks to the timely introduction of new generating capacity.

2.20 *The wholesale market* Some experienced industry observers have suggested that current wholesale market arrangements are imperfect. In particular, Lincoln Gould has argued that while the wholesale spot market is relatively efficient, there is no adequate market for trading future risk.[2] Regulatory powers relating to price relativities between urban and rural networks and the limits on fixed charges further constrain the ability of retailers to manage risk. These difficulties are arguably holding back demand-side management practices, including the spread of time-of-use metering. Gould has proposed that the best approach here would be to allow retailers to contract and spread their risks in any commercial way they wish. This includes integrating their operations with line companies. We believe these ideas should be examined in the review.

3 Lessons to be drawn

3.1 The current renationalisation of the electricity sector, if taken to its logical conclusion, would be likely to return New Zealand to the historical situation of periods of under-supply and brown-outs followed by fast-track environmental legislation to allow new capacity to be built. This would lead to periods of over-supply and the equivalent of 'Think Big' schemes to remove embarrassing surpluses. Prices to customers would be politicised and, based on past experience, would involve significant hidden cross-subsidies.

3.2 The previous government created a hostile environment for private sector participation, as evidenced by TransAlta's withdrawal from the market. The environment is now more hostile, with no end in sight to the potential for further regulatory interventions and uncompensated regulatory takings. We believe that it is not being unduly alarmist to suggest that the risks of a California-style electricity crisis in New Zealand will continue to rise.

3.3 This is not a simple matter of blaming government. There has been relentless pressure on governments from self-interested user groups and competitors with relatively little to lose to regulate network industries. Their arguments should be regarded as suspect. Pressures from environmental groups for more regulation should be treated with scepticism.

3.4 Too many commentators simply assume that regulation must do more good than harm if a market cannot be as perfect as in the textbook case. One energy

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1 James Buchanan and Yong Yoon (1998), 'Symmetric Tragedies: Commons and Anticommons', *Journal of Law and Economics*, Vol XLIII, April.

2 Lincoln Gould, 'Distorted Structure Makes More Power Crises Inevitable', *The Independent*, 15 August 2001.

consultant writing in *The Independent* recently asserted that "New Zealand is too small for a fully competitive wholesale electricity market" and argued this was a ground for further regulation.[3] His analysis assumed the existence and efficacy of complex and well-informed analysis by 'impartial' experts. If such omniscient beings existed New Zealand would not need markets. Unfortunately, the reality of problems of information, factional interests and the potential for the misuse of regulatory powers cannot be assumed away.

3.5 With the government being involved so extensively in the industry it is hard to see that it will be able to resist the current drift to ever-heavier regulation and greater state ownership and control. We consider that the review will serve little purpose if this issue is not confronted squarely. The government should have the benefit of rigorous advice that is free from presumed political constraints. It should not set its face on ideological grounds against conclusions that the state domination of the industry should be reduced. Any changes to regulation should meet the tests laid down in the Regulatory Impact Statement procedures.

3 John Noble, 'Electricity Problem: Drought or a Dearth of Ideas', *The Independent*, 29 August 2001.

EDUCATION AND THE LABOUR MARKET

BUSINESS INFORMATION IN ACTION
WORKRELATIONS NZ CONFERENCE

ASSESSING THE EMPLOYMENT RELATIONS ACT

ROGER KERR
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NEW ZEALAND BUSINESS ROUNDTABLE

WELLINGTON
19 NOVEMBER 2001

ASSESSING THE EMPLOYMENT RELATIONS ACT

In my view a good deal of commentary about the Employment Relations Act 2000 (ERA) has been misdirected. I want to open this panel discussion by making six brief points.

First, the standard of reference in judging the ERA should not be the Employment Contracts Act 1991 (ECA) but rather the best possible employment regime that New Zealand could put in place. The ECA had the merit of being based on the principle of freedom of contract but it departed from that principle in practice, for example, by having mandatory personal grievance procedures and a specialist court. Court rulings further undermined freedom of contract. Over time that had a stifling effect on economic and employment growth. Other employment legislation like the Holidays Act 1981 limits free contracting and treats employers and employees as children, not adults. Countries like the United States and the United Kingdom don't legislate for holidays.

Second, it follows that the key issue in judging the ERA is whether it is a step in the right direction or the wrong direction. I see it as a backward step. Removing individual freedom of contract is anti-worker and anti-employer, and the likely effect is to depress real wage rates. The Employment Court has described the ERA as a "return to collectivist principles" and a discarding of the previous contractual bargaining model. The ECA did not discourage collective bargaining or unions but nor did it encourage them – it was rightly neutral. But, collectivism on anything other than a voluntary basis is not the way of the future. Most people want to be treated as individuals, and unionisation rates continue to fall in most countries – to 13.5 percent of total employment in the United States last year, and under 10 percent in the private sector. Margaret Wilson's goal (as minister of Labour) of increasing unionisation to 30 percent of the workforce in New Zealand flies in the face of workplace realities.

Third, the ERA did not return New Zealand to compulsory unionism, compulsory arbitration and national awards (despite a hankering in some quarters for multi-employer contracts). Like the ECA, it is primarily an enterprise-focused regime. Therefore – and having regard to other changes such as the opening up of the economy and changes in management practice – no one should have expected radical changes in behaviour, at least in the short term. The ERA is best understood as a shift towards European labour market models, with their emphasis on protection for existing jobs, and away from the freer US-style regimes.

Fourth, much commentary has been about things like the incidence of disputes, whether the mediation service is doing a good job or not, and whether there is less work for lawyers (as was intended) or more. These are easy for lazy commentators to focus on but not the most meaningful indicators of whether the ERA is 'working'. Strike action has declined worldwide – inflexible and dysfunctional collective agreements and strikes are just a long-run recipe for low pay, as teachers may eventually realise. Rather, the prime focus should be on whether a country's employment framework makes it a place where it is easy to do business and that is attractive to investment.

Fifth, in this regard, I think the lessons from international experience are clear-cut. Employment regimes rank with tax regimes as key factors in global competition for business investment. Europe's labour laws and practices may protect existing jobs in the short run but at the expense of high unemployment for labour market 'outsiders' and of the economic dynamism which creates both greater prosperity and security in the long run. Recognising this, several European countries have taken some steps to introduce greater flexibility. The freer US environment encourages risk-taking, innovation and the development of new industries, and much higher levels of employment. Venture capitalists won't put money into risky, new technology enterprises if they can't cut their losses and lay off staff easily if they don't work out. The Australian Labor Party wanted to move employment law in the direction of the ERA but the newly elected Liberal government wants to extend workplace reform, in particular with respect to unfair dismissals. Already some business advisers – rightly or wrongly – are saying that Australia's employment regime is more attractive to business than ours. That contrasts with views in the mid-1990s and is not good news.

Finally, the overall basis for judging the ERA is not whether it has caused the sky to fall in but whether it risks causing death by a thousand cuts. In making this judgment the ERA should not be viewed on its own – it should be seen alongside other initiatives such as the renationalised accident compensation scheme and proposed legislation on the transfer of undertakings, health and safety, parental leave and holidays, and other regulatory and tax initiatives outside the employment area. All this is making it harder to do business in New Zealand. Small business in particular can't hope to know for sure what a court might find 'good faith' bargaining to mean. The consequence is likely to be less investment, thus less capital and new technology for workers to work with, and hence lower growth in wages and higher unemployment.

New Zealand should be going in the opposite direction, particularly given its natural disadvantages, and seeking to 'stand out from the crowd' by creating the best possible business-friendly and worker-friendly employment framework. The essence of this is a regime based on the principle of free contracting, not on the fallacies of bargaining inequality and collectivism that underlie the ERA. The acid test of whether this assessment is right is whether the ERA and associated changes will achieve the prime minister's goals for New Zealand of average incomes in the top half of the Organisation for Economic Cooperation and Development range and an unemployment rate of 3 percent or whether it is a recipe for slow growth in real wages and European-style unemployment. Commentators should be monitoring progress against this test.

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE TERTIARY EDUCATION REFORM BILL

MARCH 2002

1 Introduction

1.1 This submission on the Tertiary Education Reform Bill (TERB) 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 In our submission, we do not undertake a clause-by-clause analysis of the TERB. Rather, we:

- discuss some of the broad policy issues arising from the TERB;
- highlight areas of the TERB that we support and those where we have concerns; and
- suggest ways in which the TERB measures could be implemented so as to increase the likelihood that the reforms will generate net benefits to the country.

1.3 We also identify a number of wider policy reforms that would help achieve the goals being sought by the government through the TERB.

2.0 Summary

2.1 Key points in the submission are as follows:

- The NZBR supports some aspects of the TERB and associated reforms, including its focus on objectives, information and sector performance.
- At the same time, we are concerned that the underlying justification for the increased centralisation of decision-making authority in the tertiary sector is weak. For example, there is little evidence that competition is having an adverse impact on sector outcomes.
- We have considerable reservations that central 'steering' will deliver better outcomes than could be realised under a more decentralised system. The current system is not perfect by any means. However, a range of reforms aimed at supporting the operation of a decentralised system, including better quality assurance mechanisms, improvements to institutional governance and better information, would likely yield superior outcomes to what is being proposed in the TERB.
- The success or otherwise of the TERB proposals will depend on the way it is implemented.
- To the extent that the various regulatory instruments such as the Tertiary Education Strategy (TES), the Tertiary Education Commission (TEC) and charters and profiles are used to micro-manage the sector, they will introduce rigidities into the system, weaken market signals and frustrate, rather than promote, the achievement of government objectives.
- In our view, the only way that the TERB approach will generate net benefits to the country is if it is implemented in a 'light-handed' manner, with the government and the TEC focusing predominantly on information provision and performance measurement.

- While we believe that an alternative policy direction to that outlined in the TERB would be preferred, we also believe that the TERB could be improved in a number of ways. These include making changes aimed at reducing the scope for arbitrary decision making, ensuring that the assessment criteria are based on well-founded public policy criteria and ensuring participation by, and consultation with, stakeholders, including business and enterprise.
- Whether the TERB goes ahead or not, a range of wider, more fundamental tertiary education reforms should be considered, including eliminating the fee-stabilisation programme, revamping governance arrangements and reversing recent student loan changes, all of which were identified as issues by the Tertiary Education Advisory Commission (TEAC).
- We recommend against industry levies. If, however, the government proceeds with them, we recommend that levies only be put to a ballot where they meet a strict desirability test, as currently exists with the Commodity Levies Act 1990. The ballot threshold should be set much higher than is currently proposed.

3.0 Key elements of the TERB

3.1 The TERB has been developed as a response to the first two reports of the TEAC. Consistent with TEAC's work, the stated rationale for the changes is to make more strategic use of resources through a more cooperative and collaborative tertiary education sector. Broadly, the TERB provides for greater centralisation of decisions and more power for the Associate Minister of Education (Tertiary Education).

3.2 Key elements of the TERB are as follows:

- the Tertiary Education Commission (TEC) will be established from 1 July 2002, with a board of six to nine people. The board will make the key decisions, not the staff;
- the minister will set a long-term Tertiary Education Strategy and a shorter-term Statement of Tertiary Education Priorities, to be implemented by TEC;
- all funded providers will have to prepare five to 10 year charters and three-year profiles (updated annually) for negotiation with the minister and TEC, respectively. Providers will need to consult with stakeholders over charters, at least;
- the minister will approve funding mechanisms, prepared by TEC, although the minister can not intervene in a particular organisation's funding;
- a new class of Tertiary Education Institution (TEI) – specialist colleges – will be established;
- the New Zealand Qualifications Authority (NZQA) will be able to suspend or place conditions on registration, course approval and accreditation; and

- Industry Training Organisations (ITOs) will be required to forecast skills for their industry and will be able to ballot their industry to determine whether an industry levy should be established.

4.0 Assessment of TERB

4.1 Regulatory approach underlying the TERB

4.2 There are several positive aspects to the TERB and associated reforms. These include:

- the TES can help to focus tertiary sector participants and the government on sector objectives, outcomes and performance, rather than focusing on the means of achieving these objectives;
- the TERB and associated reforms put considerable focus on the role of information in supporting the operation of the education and labour markets. This was true, for example, of the November 2001 package[1] of skills forecasting initiatives, which focused on increasing market transparency and forecasting future skill needs, rather than attempting 'old-style' workforce planning;[2]
- the unified funding framework for the tertiary education sector will provide greater coherence in the way the sector is funded; and
- charters and profiles could push tertiary institutions (state and private) to put a greater emphasis on strategic planning, an area identified as a weakness by the Tertiary Capital Charge Task Force and Steering Group during the mid 1990s.

4.3 At the same time, however, we are concerned that the underlying policy of increased centralisation of decision-making authority in the tertiary sector is mistaken. One of the justifications for this proposed policy direction is that a more 'centralist' and less 'competitive' approach is required to ensure that tertiary education in New Zealand makes more strategic use of available resources. For example, the second TEAC report, which recommended the adoption of charters, profiles and the TEC, argued, *inter alia*, that:

- 'excessive reliance' on a demand-driven funding system and competition has had a number of adverse impacts on the tertiary education sector, including creating pressures on providers to compete across a wide range of disciplines and causing a proliferation of courses; and
- the government has limited capacity to intervene in the tertiary sector to protect the national interest.[3]

4.4 A key concern is that neither the second TEAC report nor the TERB provides any justification or evidence to support the policy approach that underlies the

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1 Maharey, Hon Steve (2001), *Government to introduce skills forecasting*, Press Release, Government of New Zealand, 14 November.

2 Willems, Ed (1996), *Manpower Forecasting and Modelling Replacement Demand: An Overview*, Research Centre for Education and the Labour Market, Maastricht.

3 Tertiary Education Advisory Commission (2001), *Shaping the System*, Wellington, pp 8–9.

TERB. Yet, the approach has potentially far-reaching implications. There are several key issues that have not been addressed. For example:

- it is not clear that the TEAC characterisation of the tertiary sector is accurate. In particular, no evidence is provided to support the view that sector is too 'competitive', that there is a lack of cooperation/collaboration in the sector, or that the sector is insufficiently strategic;
- the underlying view that competition is 'bad' is not supported by the evidence, either in the education sector or in other parts of the economy. Moreover, competition arises because resources are scarce (that is, there are more wants than can be satisfied with available resources). The Tertiary Education Advisory Commission did not recognise this fundamental point. Its proposals do not overcome scarcity; they merely change the process by which resources would be allocated among competing uses;
- it is not clear why a competitive model of tertiary education would generate 'too little' cooperation and collaboration, when other, more competitive sectors exhibit significant collaboration; and
- it is not clear that the proposed 'centralist' approach to steering the tertiary education system via charters and profiles will yield better tertiary outcomes than the 'decentralised' system currently in operation.

4.5 This is of concern given that good problem definition is essential to developing an appropriate policy package. Indeed, poorly specified problems can lead to poorly specified solutions. A strong policy platform is essential if policy changes are to be effective and durable.

4.6 It is not clear that the TEAC/TERB characterisation of the tertiary education sector is accurate. Contrary to this view, a cursory glance at the sector suggests that it is not homogeneous and that in fact there is a fair degree of specialisation. For example:

- different institutions have developed expertise in particular programme areas (for example, public administration at Victoria University, medical sciences at Otago University);
- institutions go to great lengths to differentiate themselves, through various means, including the development of a different institutional focus and emphasising non-academic factors such as lifestyle;
- many private training establishments (PTEs) focus delivery on a narrow range of courses and do not compete directly with the 'full-service' state institutions that are their main competitors;
- the tertiary sector is far more differentiated than the more heavily regulated and less 'competitive' school sector in New Zealand; and
- institutions may differ along many dimensions, even if they have similar course and programme offerings (for example, applied versus theoretical focus, pastoral care, size).

4.7 The view that the tertiary sector is not homogeneous is supported by the Organisation for Economic Cooperation and Development (OECD) which, in 1997, described the New Zealand tertiary sector as follows:

> There is a considerable measure of specialisation in the tertiary system, not only through the sectors which comprise it (universities, polytechnics, colleges of education, Wananga – specialist Maori institutions – and private training establishments – PTEs) but also within each of the sectors. The universities, for example, while offering a broad range of programmes, specialise in certain fields.[4]

4.8 A second underlying premise of the TEAC and the TERB is that competition in the tertiary education sector is somehow bad. In our view, it is not clear why competition and 'duplication' are inherently undesirable in tertiary education.

4.9 Competitive markets are a reality across a wide range of sectors of the economy – including education. Competition is generally seen to be a good thing. It offers consumers convenience and choice, and ensures that providers have strong incentives to innovate, to be responsive to customer demands, to provide the levels of quality desired by consumers and to deliver services in an efficient manner. Neither TEAC nor the TERB provides reasons why competition would have the opposite effect in the state tertiary education sector. Nor do they explain why tertiary education might be different from other goods and services, for example, general medical practitioner services, where competition is seen as providing better outcomes for consumers.

4.10 Regulatory reform initiatives aimed at promoting competition have been successfully applied across a wide range of sectors in the economy – including areas where competition was previously not seen as viable. These include public transport and social services such as health and education.

4.11 A number of studies covering a range of 'economic' sectors and countries have examined the experience with deregulation and the introduction of competitive forces. These studies have identified significant gains from regulatory reform – including higher quality, lower consumer prices, greater choice and increased innovation. For example:

- Guasch and Hahn cite significant efficiency gains from regulatory reform in developing countries across a range of industries;[5]
- an OECD review of economic deregulation initiatives in the United States concluded, *inter alia*, that more vigorous competition in network industries "stimulated industry restructuring and innovation and benefited consumers through better service and lower prices";[6]

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4 Organisation for Economic Cooperation and Development (1997), *Thematic Review of the First Years of Tertiary Education, Country Note: New Zealand*, Paris, p 12.

5 Guasch, J Luis and Robert W Hahn (1999), 'The Costs and Benefits of Regulation: Implications for Developing Countries', *The World Bank Research Observer*, Vol 14, No 1, pp 137–158.

6 Organisation for Economic Cooperation and Development (1999), *The OECD Review of Regulatory Reform in the United States*, preliminary edition, Paris, p 17.

- Winston found that deregulation had led to price declines ranging from 30–75 percent across a range of industries, including airlines, trucking, railroads and banking;[7] and
- Crandall and Ellig found that regulatory reform and the introduction of customer choice in five 'network' industries led to improvements in service quality and price reductions. They also found that regulatory reform had generated gains for consumers and for society as a whole.[8]

4.12 In Australia, the National Competition Council has observed that:

> Competition contributes to achieving higher growth by helping to ensure that the community's resources – the physical environment, financial resources and people's skills and ideas – are used in the most valuable way. Accordingly, Australia's governments have taken the logical view that the disciplines imposed by effective competition, being the greatest drivers for improving productivity and encouraging innovation, need to be extended throughout all sectors of the economy…[9]

4.13 Choice and competition can also deliver gains in the education sector. While the empirical evidence is not as extensive as in the economic sectors, there is nonetheless a growing body of empirical evidence identifying gains from competition at both the school and tertiary education levels. For example:

- Hoxby examined choice reforms in three US jurisdictions and found that, in each case, regular public schools increased educational achievement per dollar spent when exposed to competition;[10]
- Hoxby also examined the impact of Catholic schools (the main class of private schools in the United States) on public schools and found that public schools in areas with larger concentrations of Catholic schools performed better across a range of indicators;[11]
- Hanushek and Rivkin provide some initial evidence that more competition tends to increase teacher quality, particularly for schools serving predominantly lower income students from lower income backgrounds;[12] and

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7 Winston, Clifford (1998), 'US Industry Adjustment to Economic Deregulation', *Journal of Economic Perspectives*, Vol 12, No 3.

8 Crandall, Robert and Jerry Ellig (1997), *Economic Deregulation and Customer Choice: Lessons for the Electricity Industry*, Center for Market Processes, Fairfax, Virginia.

9 National Competition Council (1997), Competitive Neutrality Reform: Issues in Implementing Clause 3 of the Competition Principles Agreement, AGPS, Canberra, p 1.

10 Hoxby, Caroline Minter (2001), *School Choice and School Productivity (or, could school choice be a tide that lifts all boats?)*, paper prepared for the Economics of School Choice Conference, National Bureau of Economic Research, Cambridge.

11 Hoxby, Caroline Minter (1994), *Do Private Schools Provide Competition for Public Schools?* NBER Working Paper No W4978, Cambridge.

12 Hanushek, Eric and Steven Rivkin (2001*), Does Public School Competition Affect Teacher Quality?*, paper prepared for the Economics of School Choice Conference, National Bureau of Economic Research, Cambridge.

- studies by Zanzig,[13] as well as Borland and Howsen[14] found that increased competition among public school districts – in California and Kentucky respectively – enhanced student test scores.

4.14 Lori L Taylor, who has written widely on school competition issues, 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. Almost across the board, researchers have found that school spending is lower, academic outcomes are better, and school-district efficiency is higher where parents have more choice in their children's educational provider. Furthermore, competitive benefits emerge regardless of whether the competitor is a private school or another public school. Thus, the literature offers support for the notion that increased school competition – fostered either by vouchers or charter schools – would improve the public school system.[15]

4.15 In commenting on Britain's experience under the Blair government, Howard Glennerster of the London School of Economics has noted that, despite stagnating education spending, education outputs (that is, outcomes) grew in a way "unseen in thirty years". According to Glennerster:

> The reason seems to be that a degree of competition, devolved budgetary responsibility, the setting of national standards and required following of good practice produced results … Head teachers now seem to strongly appreciate the degree of managerial freedom the devolved budgets have brought. The numeracy and literacy hours seem powerful ingredients. In short, it is doubtful if any one of these measures on their own would have produced the change. It would certainly be premature and retrograde to go back on any of them now.[16]

4.16 New Zealand's experience with competition at the school level, though often criticised, has been positive. The broadly 'market-based' New Zealand reforms

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13 Zanzig, Blair R (1997), 'Measuring the Impact of Competition in Local Government Education Markets on the Cognitive Achievements of Students', *Economics of Education Review*, 16, pp 431–444.

14 Borland, Melvin V and Roy M Howsen (1992), 'Student Academic Achievement and the Degree of Market Concentration in Education', *Economics of Education Review*, 11, pp 31–39; Borland, Melvin V and Roy M Howsen (1993), 'On the Determination of the Critical Level of Market Concentration in Education', *Economics of Education Review*, 12, pp 165–169; Borland, Melvin V and Roy M Howsen (1996), 'Competition, Expenditures and Student Performance in Mathematics: A Comment on Couch et al', *Public Choice*, 87, pp 395–400.

15 Taylor, Lori L (2000), The Evidence on Government Competition, *Economic and Financial Review*, Second Quarter, Federal Reserve Bank of Dallas, Dallas, p 7.

16 Glennerster, Howard (2001), *United Kingdom Education 1997–2001*, London School of Economics, London, p 11.

have led to increased diversity of supply and choice for consumers, especially among those from low socio-economic groups, Maori and Pacific peoples.[17]

4.17 While the rhetoric of the various Smithfield Project reports has generally been anti-choice and anti-competition, their results have actually revealed the opposite – that the introduction of competition has had a number of benefits. For example, the Smithfield reports showed that, after the abolition of zoning:

- Maori and Pacific peoples made the greatest use of parental choice. The biggest increases in students not attending their nearest school was among these groups – fully one-third of them were not attending their nearest school after the abolition of zoning – versus 26 percent for Pakeha; and
- income segregation in public schools fell after choice was introduced – contradicting the so-called 'polarisation' hypothesis. For example, the Smithfield work found that income segregation was lower in 1993 than in 1990, the final year of zoning.[18]

4.18 Gorard and Fitz found similar results for England and Wales regarding the impact of 'market-based' policies on segregation. In the case of England, their research showed that the stratification of the school system along socio-economic lines decreased after the introduction of limited competition under the 1988 Education Reform Act.[19]

4.19 While the arguments in favour of competition are strong at the school level, they are even stronger at the tertiary education level. As Johnstone has argued, higher education satisfies many of the conditions of a private good, which makes it amenable to market allocation. In particular:

- higher education does not have the characteristics of a purely public good (that is, non-rivalry, non-excludability); and
- consumers of higher education are reasonably well informed and providers are often ill informed.[20]

4.20 In a submission to the Review of Higher Education Financing and Policy (the West Committee) in Australia, the Australian Industry Commission supported a market-oriented approach to higher education on the grounds that it would:

- establish a strong customer–supplier relationship between students and institutions;

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17 LaRocque, Norman (2001), *Shaping the Tertiary Education System: An Assessment of the Second Report of the Tertiary Education Advisory Commission*, The Education Forum, Auckland, www.educationforum.org.nz.

18 Harrison, Mark (2001), 'Book Review, When Schools Compete: A Cautionary Tale' by Edward Fiske and Helen Ladd, *Education Matters*, Summer, http://www.edmatters.org and Mark Harrison (1998), *Review of the Policy Recommendations from the Smithfield Project Reports*, report prepared for the Ministry of Education, Wellington.

19 Gorard, Stephen and John Fitz (1998), 'Under Starters Orders: The established market, the Cardiff study and the Smithfield project', *International Studies in the Sociology of Education*, Vol 8, No 3.

20 Johnstone, D Bruce *et al* (1998), *The Financing and Management of Higher Education: A Status Report on Worldwide Reforms*, The World Bank, Washington, DC, p 3.

- empower institutions to offer services at prices and in quantities and qualities that reflect their specific circumstances and the preferences of their students; and
- give institutions greater freedom in the types of courses they offered, including their prices and qualities, subject to government regulations relating to anti-competitive behaviour, course accreditation and related quality assurance.[21]

4.21 In the United Kingdom, the National Committee of Inquiry into Higher Education (the Dearing Committee) supported a move toward more demand-driven funding.[22]

4.22 The United States, which has arguably the best higher education system in the world – in terms of quality, diversity and levels of participation – also has one of the most competitive higher education systems in the world. This includes a very strong private education sector – both for-profit and not-for-profit. According to *The Economist*, the competitive nature of the system is one of the key reasons for its success:

> The unique advantages of America's universities go beyond the hybrid vigour of a system in which state and private institutions have all been allowed to seek out their competitive advantage. Much of the system's success derives from the readiness of American academics to let market forces work. In contrast to most countries, where pay is centrally negotiated, competing American campuses strive to outbid one another for talent …[23]

4.23 The Task Force on Higher Education and Society, in its report entitled *Higher Education in Developing Countries: Peril and Promise*, which actually argues for a stratified tertiary education structure, nonetheless supports competition. It argues that:

> … [t]he Task Force believes that more intense competition between similar institutions for faculty, students and resources will help improve standards by rewarding merit and performance. Competition also generally promotes beneficial innovations and overall quality improvements. Competition is exceedingly difficult to achieve through central decree, but requires a high degree of autonomy for academic institutions, allowing them to exploit their strengths and overcome weaknesses.[24]

4.24 In the end, TEAC and the TERB do not make the case that competition has had an adverse impact on the tertiary education sector in New Zealand. Despite the

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21 Industry Commission (1997), *Industry Commission Submission to the Review of Higher Education Financing and Policy*, AGPS, Canberra, p 22.

22 National Committee of Inquiry into Higher Education (1997), *Higher Education in the Learning Society*, report of the National Committee of Inquiry into Higher Education, http://www.leeds.ac.uk/educol/ncihe, London.

23 *The Economist*, 'The Core and the Cloud', 4 October 1997, p S20.

24 Task Force on Higher Education and Society (2000), *Higher Education in Developing Countries: Peril and Promise*, The World Bank, Washington, DC, pp 50–51.

strength of its views, the Commission does not even make the case that the weaknesses it identifies are real and pervasive.

4.25 This is of concern because so much of the proposed approach is built on the assertion that an "excessive reliance" on competition has harmed the tertiary sector. It is important that real problems be linked to their real causes and that feasible alternatives are compared on a like for like basis. This is especially true given the overwhelming evidence from other sectors that competition is a good thing.

4.26 One of the hallmarks of the TEAC/TERB approach to funding and regulating the tertiary education sector is the desire for greater centralised 'steering' of the system. Under the TERB, this is to be effected through a system that includes the TEC, the TES and institutional charters and profiles. While the funding mechanism is not spelled out in the TERB, the new system will introduce what TEAC described as a 'desirability' test to determine which courses/ programmes ought to be offered and/or funded.

4.27 It is not clear that the proposed allocation mechanism will deliver a better or more 'strategic' allocation of resources than the current market-based system. Indeed, there are good reasons to believe that a centralised system will be inferior. This is because central planners have neither better information nor better incentives than students and tertiary institutions to guide them in the difficult task of interpreting market signals as to which skills are in demand and hence which courses ought to be taught.

4.28 One of the key advantages of the market system is that it can better overcome the information problem. Central planning requires a great deal of quality, timely information if it is to be done well. Even in a country as small as New Zealand, information is costly or even impossible to obtain. The multi-dimensional nature of education means that the central planner must know what courses and programmes are in demand, when and where they are in demand, whether students would prefer to study full year, part-year, full-time, part-time or whether they want to study extramurally. They must also know the 'quality' of tuition that students desire, how much students are willing to trade off price for quality and whether students prefer an 'academic' or 'applied' treatment of a subject.

4.29 At the same time, the central planner must know which institutions would be best placed to deliver the courses and programmes in demand, what mode of delivery is best, and so on. As Mark Harrison has noted:

> The advantage of competitive markets is that they make use of decentralised knowledge, as consumers know their preferences and producers know their own production functions. For example, students have better information than the central department on the effectiveness of teaching and consumption benefits associated with university life. In a market system, price signals provide information to producers on the value students place on different educational packages and provide the incentive for producers to respond to those preferences. The market coordinates the subjective judgements of suppliers and demanders. Whether

> higher quality is worth the extra costs is tested by whether consumers are willing to pay for the higher quality product.[25]

4.30 The information challenges for the central planner are becoming more severe over time given technological developments, globalisation, changing demographics, the move to mass tertiary education and the increasing sophistication of consumers. The current decentralised system – where decisions regarding courses and programmes are made by students and tertiary institutions – is far more likely to produce the skills that the economy needs. It is also far more likely to be responsive to changes in demand and to respond to new opportunities – whether in the areas of information technology, biotechnology or mental health.

4.31 Nicholas Barr and Iain Crawford argue against central planning on the following basis:

> Today … there are many more students, the training they require is much more diverse and it is changing … [T]he task has become vastly too complex for central planning to be possible any longer … [N]either is central planning desirable … [s]tudents are more capable of making the necessary choices … [a]nd will, in future, be capable of making more complex choices provided they have the necessary information … [s]trong changes in demand will require universities to respond in ways which are wholly impossible within a centrally planned funding mechanism. Universities have to be free to decide the prices they charge, the types of courses and the number of places … [S]tudent demand will be more attuned to continually evolving employer demand than central planning ever could. If the government wishes to influence outcomes (e.g., to encourage more students to study engineering), they would do so by providing financial incentives for relevant courses.[26]

4.32 An additional concern is that decisions regarding funding allocations will be subject to government failure. Politicians and politically appointed boards such as the proposed TEC, even with adequate information, will not be making decisions in a vacuum. The political process may generate pressures to favour particular courses or programmes, institutions or regions over others. The interests of producers, who are generally well organised and well financed, are likely to dominate the interests of consumers or other groups, whose power is diffuse. The recent controversy over funding of PTEs is a case in point.

4.33 A second concern with the proposed approach is the emphasis it places on ensuring that courses are in the 'national interest'. The notion of what is in the 'national interest' is extremely difficult to define and to put into practice. Determining which courses are in the 'national interest' involves, to some degree, 'picking winners'. This is an area where governments have typically shown little comparative advantage, as evidenced by the Think Big projects of the 1970s. The process of determining and identifying what is in the national

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25 Harrison, Mark (1997), *Review of Tertiary Funding Arrangements and Options for Change*, report prepared for the New Zealand Treasury, New Zealand Treasury, Wellington, p 5.

26 Barr, Nicholas and Iain Crawford (1998), 'Funding Higher Education in an Age of Expansion', *Education Economics*, Vol 6, No 1, p 48.

interest is fraught with political danger and open to capture by well-organised interests.

4.34 There is a further risk that the Crown's ownership interest will dominate its purchase interest in the determination of what is in the national interest. Politicians and the TEC would find it difficult to resist pressure to use the funding allocation process to prop up poorly performing state tertiary institutions. While this is an issue now under the current system, it is likely to be much greater under a centralised system. The multiple roles and unclear objectives of the TEC would exacerbate this risk.

4.35 Once again, the question is whether students and tertiary institutions or the central bureaucracy have better information for making judgments as to which course or programme is the right one for the student. The informational advantages and better alignment of incentives suggest that students are better placed. Evidence from the United States suggests that students generally make good choices when it comes to the type of education or training they will undertake. They are able to perceive the fields where demand is strongest and take account of the costs of undertaking the education. Average student expectations about the rates of return to education are close to actual market outcomes.[27] Heijke (1996) has noted that "[T]hese research results indicate that students apparently pay considerable attention to the labour market when they are deciding whether to study further, and that they are also able to form a general picture of their perspectives in the labour market …"[28]

4.36 The task of determining which programme areas will serve the 'national interest' is not an easy one for central planners. The experience in the teaching sector is salutary.[29] Mark Blaug argues that the best approach to labour market planning is to increase the flexibility of the educational system so that it can respond to forecasting errors.[30] If the problem is one of poor information regarding career choices, then it is appropriate to address that problem.[31] To the extent that the TERB proposals introduce new rigidities into the tertiary education sector, they will act to worsen labour market planning.

4.37 As noted above, we have significant concerns with a 'centralist' approach to regulating the tertiary education sector. In our view, market mechanisms operating within a decentralised system are most likely to assist in meeting the government's objectives. The current system is not perfect by any means. However, a range of reforms aimed at supporting the operation of a decentralised system, including better quality assurance mechanisms, improvements to institutional governance and better information, would likely yield superior outcomes to what is being proposed in the TERB.

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27 Harrison, Mark (1997), *op cit*, p 41. Harrison cites a number of further sources of evidence.

28 Heijke, Hans (1996), *Labour* Market *Information for Educational Investments*, Working Paper, Research Centre for Education and the Labour Market, Maastricht, p 6.

29 Scanlon, Sean, 'Staffing Crisis Looms as NZ Teachers Snap up Work Overseas', *The Press*, 5 January 2001 and Kristin Rushowy, 'Qualified Substitute Teachers in Short Supply', *The Toronto Star*, 11 December 2000.

30 Blaug, Mark (1970), *An Introduction to the Economics of Education*, Penguin, London.

31 Harrison, Mark (1997), *op cit*, p 41.

4.38 In the end, however, the degree to which the above criticisms apply will very much depend on the way the TERB proposals are implemented. In our view, a critical factor in determining the success or otherwise of the TERB will be the way it is implemented. This is because the powers in the TERB are broad and enabling, rather than prescriptive. It will give the minister and the TEC considerable leeway in how their new powers are used.

4.39 To the extent that the various regulatory instruments such as the TES, the TEC and charters and profiles are used to micro-manage the sector, they will introduce rigidities into the system and weaken market signals – the primary means of information dissemination in the sector. Rather than add value, such an approach would give rise to considerable institutional 'gaming' of the system, increased red tape, higher costs and a lengthening of the 'time to market' for new courses and programmes. In the end, a heavy-handed regulatory approach would be likely to frustrate, rather than promote, the achievement of government objectives.

4.40 In our view, the only way that the TERB approach will generate net benefits to the country is if it is implemented in a 'light-handed' manner (as recommended by the Working Party on Charters and Profiles[32]), with the government and the TEC focusing predominantly on information provision and performance measurement. Implementation in this way would provide greater scope for the new regulatory instruments to strengthen, rather than supplant, market mechanisms. Even with that, the danger of a heavy-handed system remains if the legislation is passed as is.

4.41 While we believe that an alternative policy direction to that outlined in the TERB would be the best way to go, we also believe that the TERB could be improved in a number of ways. We would recommend:

- limiting the scope for arbitrary decision making by introducing decision-making criteria to guide both ministerial and TEC decisions (for example, funding decisions under section 159, course approvals under section 258, accreditation conditions under section 259, and so on). Currently, these sections are not specific as to what factors ought to be taken into account when making decisions regarding funding, approvals, accreditation, and so on. The TERB would appear to be far less specific about the funding system than is the current legislation;
- ensuring that the criteria used in determining funding allocations (at an institutional, sub-sector or sector wide level) under section 159, course approvals under section 258, accreditation conditions under section 259, and so on are based on well-founded public policy criteria such as nature of output, cost, quality and performance; and
- strengthening legislative requirements for participation by, and consultation with, stakeholders, including business and enterprise.

4.42 We would commend the Business New Zealand submission to the Committee as it provides detailed drafting suggestions to achieve these ends.

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32 Working Party on Charters and Profiles (2001), *Report of the Working Party on Charters and Profiles*, Government of New Zealand, Wellington, p 6.

4.43 Introducing the above safeguards would help to ensure that decisions regarding funding, approvals or accreditation did not reflect ‘extraneous’ factors such as the ownership status or the corporate structure of an institution, unless these were of relevance to the decision. There is a very real risk that such factors could play a significant role in decisions in the current environment – witness the recent funding moratorium on PTEs, as well as policy decisions on financial assistance to students at private teacher training colleges, private school funding caps, distinctions being drawn between for-profit and not-for-profit early childhood centres and attempts to coax ITOs into using state institutions rather than private ones.

4.44 We would also recommend that, where the TEC does attempt to guide the nature of provision in the sector, it does so via the setting of subsidy rates, rather than through the use of quantity limits based on charters and profiles. Thus, any move to encourage growth in specific areas should be carried out by altering subsidy levels and then allowing market mechanisms to determine provision. In our view, control via charters and profiles would require far too much information. In particular, there are significant risks that the charters and profiles process could be used to favour particular types of provider over others, for no good public policy reason.

4.45 In addition, the government could consider making the TEC a more autonomous body, free of any potential for political or other interference. There is a significant risk of this happening in the current environment. The TEC could be guided by government priorities and fiscal constraints.

4.46 The TERB allows the government to impose a training levy on the members of an industry, payable to an ITO, if there is sufficient support for the imposition of that levy following a ballot of those members.

4.47 We are opposed to industry levies. In our view, the case for them is weak. The justification offered for levies often rests on the proposition that employers ‘free-ride’ on the training investments made by other employers. This is said to occur because the returns from training accrue after the costs of training are incurred. However, such concerns are overstated. There are two reasons for this:

- more than 50 percent of the up-front costs of training is paid for by the government; and
- the relatively flexible contracting that exists under the Employment Relations Act 2000 allows employers to protect their investment through various contracting mechanisms such as bonds.

4.48 Levies can also impose a range of economic costs on employers. These are costs similar to those incurred with general taxes, effects on employment relationships and the work/learning environment, and incentives for lobbying to acquire or retain levy powers. Levies could also reduce the responsiveness of ITOs to the needs of employers and trainees. Incentives to serve their members wane considerably once survival does not depend on attracting members or clients.

4.49 We recommend that the relevant sections of the TERB relating to levies be abandoned. If, however, the government wishes to retain these sections in the TERB, we would recommend that ITOs be required to meet a very high threshold in making the case that a levy should be imposed. This would include providing evidence to justify its imposition, and an assessment of costs and benefits (for example, a regulatory impact statement).

4.50 As currently drafted, the TERB does not appear to require either of these, with most of the focus being placed on the ballot as the mechanism for determining the 'need' for a levy. This contrasts with similar legislation such as the Commodity Levies Act 1990, which requires, *inter alia*, the applicant to show either:

- that it would be impossible or impracticable to finance the doing out of voluntary levies of the things for which the levy is to be spent; or
- that the doing of the things for which the levy is to be spent were paid for out of voluntary levies, persons who chose not to pay those levies would derive unearned benefits from the doing of those things.[33]

4.51 In short, we believe that the imposition of such a levy should be subject to a desirability test, as well as a ballot.

4.52 We also believe that the ballot threshold should be set much higher than is proposed. As currently drafted, a levy could be imposed if only 36 percent of the industry agrees. While this may not happen that often in practice, it remains a possibility. This threshold appears to be much lower than that required under similar legislation such as the Commodity Levies Act 1990, which seems to require that "considerably more than half" of all producers (or whatever measure is used) to support it, not just those who voted.

5.0 Conclusion

5.1 The Learning for Life and subsequent reforms ushered in a new era for tertiary education in New Zealand. The new funding system, the introduction of fees, the expansion of the private education sector, the student loan scheme and the self-managing nature of tertiary institutions have changed the face of the tertiary sector. These changes have, by and large, been for the better. Participation is up significantly and the sector is far more diverse than in the late 1980s. These gains have been broad-based, with Maori the greatest beneficiaries in terms of increased participation.

5.2 Despite this progress, the tertiary education sector in New Zealand faces a number of significant challenges, including changing demographics, changes in the world of work, changing labour market skill needs and rapid technological advancement.[34] These can't be stopped. It is therefore imperative that the tertiary sector be able to meet these challenges and deliver the skills that New Zealand needs to compete in the knowledge society. Few would argue otherwise.

5.3 The second TEAC report set out, and the TERB proposes to put in place, a more centralist regulatory framework that its framers believe offers a

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[33] See Commodity Levies Act 1990, s 4.

[34] See LaRocque, Norman and Jonathan Kaye (2001), *The Times They Are A-Changin': Polytechnics and the New Tertiary Environment*, report prepared for the Association of Polytechnics in New Zealand, Wellington.

prescription for meeting these challenges. This submission has highlighted some of the strengths and weaknesses of the proposed approach.

5.4 We have considerable reservations that central 'steering' will deliver better outcomes than could be realised under a more decentralised system. The previous system was not perfect by any means. However, a range of reforms aimed at supporting the operation of a decentralised system, including better-quality assurance mechanisms, improvements to institutional governance and better information, would likely yield superior outcomes to what is being proposed in the TERB.

5.5 The success or otherwise of the TERB proposals will depend on the way it is implemented.

5.6 To the extent that the various regulatory instruments such as the TES, the TEC and charters and profiles are used to micro-manage the sector, they will introduce rigidities into the system, weaken market signals and frustrate, rather than promote, the achievement of government objectives.

5.7 In our view, the only way that the TERB approach will generate net benefits to the country is if it is implemented in a 'light-handed' manner, with the government and the TEC focusing predominantly on information provision and performance measurement.

5.8 While we believe that an alternative policy direction to that outlined in the TERB would be preferred, we also believe that the TERB could be improved in a number of ways. These include making changes aimed at reducing the scope for arbitrary decision making, ensuring that the assessment criteria are based on well-founded public policy criteria and ensuring participation by, and consultation with, stakeholders, including business and enterprise.

5.9 Whether the TERB goes ahead or not, a range of wider, more fundamental tertiary education reforms should be considered, including:

- eliminating the fee-stabilisation programme, which effectively caps student fees and starves the sector of needed revenues;
- revamping tertiary institution governance arrangements. Weaknesses in governance arrangements have been highlighted by a number of groups, including TEAC;[35]
- ensuring neutral treatment for public and private providers in terms of funding and regulation;
- a reversal of recent reforms in the area of student finance, as recommended by TEAC, with a view to restoring the student loan scheme to its pre-December 1999 status;

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[35] See for example The Treasury (1996), *Briefing to the Incoming Government*, The Treasury, Wellington; Scott, Graham and Simon Smelt (1995), *Ownership of Universities*, paper prepared for consideration by the New Zealand Vice Chancellors' Committee, Graham Scott New Zealand Ltd, Wellington; and TEAC (2001), *Shaping the Funding Framework: Fourth Report of the Tertiary Education Advisory Commission*, Wellington, pp 138–140.

- addressing quality concerns via strengthened accreditation and, in particular, making greater use of private accreditation as exists in other jurisdictions;[36] and
- splitting some proportion of funding into separate research and tuition funding and a continued targeting of research funding toward centres of excellence, whether applied or base research. We support recent government moves in that area.

5.10 We need to be realistic about what we can expect from the tertiary sector. While many observers would argue there is considerable scope for improving the sector's alignment with the country's broader needs, it is also true that no system will ever be perfect. Decentralised systems will have flaws. Equally, centrally 'planned' systems will have flaws. It is therefore important to be realistic about the limitations of both market-based systems and centrally driven systems.

5.11 The relevant question for policy makers is not 'which system is perfect?' The relevant question for them is 'which feasible system is the best?'. In the end, this must be the test applied when assessing the different options for funding and regulating the tertiary education sector.

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36 Working Party on Charters and Profiles (2001), *op cit*, p 17 and LaRocque, Norman (2001), *Regulating the Education Sector in Developing Countries, Part I*, presentation to the Adam Smith Institute Training Course *The Changing Role of Government in Education*, Sopwell House Hotel, St Albans, United Kingdom, 2–4 May.

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE HEALTH AND SAFETY IN EMPLOYMENT AMENDMENT BILL

MARCH 2002

1 Introduction

1.1 This submission on the Health and Safety in Employment (HSE) Amendment Bill 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.

2 Key elements of the HSE Amendment Bill

2.1 Broadly, the proposed changes are aimed at extending coverage of the HSE Act 1992, encouraging employee/union participation in workplace health and safety and strengthening the enforcement provisions of the Act.

2.2 Key changes in the HSE Amendment Bill are as follows:

- coverage under the HSE Act 1992 is extended to railway workers, aircraft and shipping personnel, "mobile" employees and "loaned" employees;
- the definitions of harm and hazard under the HSE Act 1992 are broadened to include mental harm and hazards arising through physical or mental fatigue;
- a duty is placed on employers to ensure that employees have the opportunity to participate in workplace health and safety management;
- employees may refuse to perform work that they reasonably believe could cause them serious harm;
- hazard notices may be issued by health and safety representatives to employers who do not address notified hazards promptly;
- maximum penalties for non-compliance with the HSE Act 1992 are increased from $100,000 to $500,000 for "serious harm" offences and from $50,000 to $250,000 for other breaches;
- employers will not be able to insure themselves against HSE Act 1992 fines, although they will be able to insure themselves against the costs of defending a prosecution;
- private prosecutions will be allowed under the HSE Act 1992 in instances where the Occupational Safety and Health Service (OSH) decides not to prosecute;
- the time limit for bringing an action under the HSE Act 1992 will be extended to six months from the time when a breach was either known or should have been known to an OSH inspector; and
- OSH inspectors will be able to issue 'spot' fines for specific offences.

3 Summary

3.1 The NZBR supports the objective of ensuring the appropriate degree of safety in New Zealand workplaces. However, we do not support the changes proposed in the HSE Amendment Bill. In our view, the appropriate test is not whether the HSE Amendment Bill is well-intentioned. Rather, the benchmark for these policy changes should be whether or not their benefits exceed their costs. In our view, the HSE Amendment Bill fails this test. Indeed, we believe that the proposed changes either will not achieve their safety objectives or will achieve them only in a way where their benefits are less than their costs.

3.2 There are several reasons for this:

- The HSE Amendment Bill shows insufficient appreciation for the significant progress that the private sector has made in recent years in addressing issues of workplace safety;
- the changes will skew the balance of instruments toward regulation rather than market mechanisms in promoting health and safety in the workplace, to the potential detriment of overall safety;
- the benefits of increased regulation and a greater OSH presence, in terms of increased safety in the workplace, are unproven;
- the changes will make the HSE regulatory environment more uncertain by introducing coverage in areas such as mobile workers and stress and fatigue;
- the changes will add significantly to the regulatory burden on all businesses and particularly on small businesses, thus inhibiting their scope to grow and innovate;
- to the extent that these changes adversely affect economic growth, they could reduce health and safety in the workplace, given that a major driver of safety is higher national income;
- changes to the HSE Act 1992 are being introduced as a means of overcoming weaknesses in other parts of the regulatory framework for health and safety, including the accident compensation scheme and tort law; and
- there is a considerable risk that the new OSH rules will become a tool for unions to use to control work processes, notwithstanding the fact that strict liability applies to employers for any contraventions of the statute.

3.3 The existing design of the HSE Act 1992 is flawed. The proposed changes will make it worse. The net costs of the proposed OSH changes are potentially significant in terms of reduced competitiveness and higher compliance costs for New Zealand businesses. Indeed, many in the business sector view the potential adverse impact of these changes as being similar in scale to the changes made to the Employment Contracts Act 1991.

3.4 The HSE Act 1992 changes will come on top of a series of recently introduced or proposed anti-growth policies, including the increased regulation of the labour market, renationalisation of the accident compensation scheme, higher taxes, the introduction of paid parental leave, planned changes to the Holidays Act 1981, higher minimum wages and ratification of the Kyoto Protocol.

3.5 The concerns of business with respect to the HSE Amendment Bill have been noted in the final report of the Ministerial Panel on Business Compliance Costs.[1]

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1 Ministerial Panel on Business Compliance Costs (2001), *Finding the Balance: Maximising Compliance at Minimum Cost*, p 6.

3.6 We are also concerned that such a significant policy change does not appear to have undergone rigorous scrutiny and, in particular, that no cost-benefit analysis has been carried out on the proposed changes.

3.7 The proposed HSE Amendment Bill should be abandoned. Instead, an independent review of the existing HSE Act 1992, and possible options for addressing existing shortcomings, should be undertaken. Other recommendations for action include facilitating the dissemination of information on best practice, examining wider policies such as accident compensation and tort reform to achieve health and safety objectives, and improving the policy-making process.

4 Background

4.1 Economic approach to the analysis of OSH

4.2 This submission adopts primarily an economic approach to the analysis of the issues raised by the changes to the HSE Act 1992. Some may be concerned that an economic approach to these issues is inappropriate given that the worth of a human being clearly goes well beyond any measurement of the economic value of a human life.

4.3 While we are not arguing that all aspects of welfare can be captured by economic measures, we nonetheless believe that an economic approach to the analysis of the issues is appropriate. There are three reasons for this, as outlined in a recent paper prepared for the International Labour Organisation (ILO):

- identifying and measuring the economic costs of occupational injury and disease can motivate greater awareness of the costs of workplace death and injuries to employers and greater awareness among governments of the impact of OSH problems on economic growth and development;
- understanding the connections between the way firms and markets function and types of OSH problems that arise is crucial to the success of public policy; and
- while the protection of worker health and well-being is important, it is not the only objective of modern society. Economic analysis can show instances where safety objectives complement other societal objectives and others where there are trade-offs between different objectives.[2]

4.4 The economics of health and safety in the workplace: A brief review

4.5 A key starting point for the analysis of the proposed changes to the HSE Act 1992 is to determine the rationale for government intervention in the area of health and safety in the workplace. Such an analysis can help identify:

- the role played by the private sector in ensuring health and safety in the workplace;

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[2] Dorman, Peter (2000), *The* Economics *of Safety, Health and Well Being at Work: An Overview*, paper prepared for the International Labour Organisation's InFocus Programme on Safety and Health at Work and the Environment, Geneva, p 2.

- the reasons why government intervention might be justified in order to ensure that there is an appropriate amount of health and safety in the workplace;
- the appropriate form that any government intervention should take in order to improve health and safety outcomes; and
- alternative policies that could be adopted in order to improve occupational health and safety outcomes.

4.6 There is an extensive literature addressing the issue of the role of the government and the private sector in promoting workplace health and safety.[3] Without going into significant detail on the economics of occupational health and safety, several points are important in evaluating the HSE Amendment Bill:

- all activities, whether at work or at play, involve risk, which can result in injury, illness or even death. Risk is not unique to the work environment. Indeed, available evidence suggests that workers in New Zealand and elsewhere are safer in the workplace than they are at home;[4]
- some, but not necessarily all, risk can be reduced or avoided to save lives and prevent accidents. Avoiding risks is costly. All decisions to reduce risk necessarily involve trade-offs between costs and benefits. Risks should only be reduced where the benefits of doing so exceed the costs. As a result, it is not feasible to eliminate risk completely since the costs of doing so would exceed benefits. People recognise this in electing to drive on the roads and in participating in sport and recreational activities;
- firms operating in an otherwise unregulated market have a strong incentive to improve safety in the workplace. This is because firms that want to attract workers into 'unsafe' work environments must pay higher wages than could be earned in 'safe' work environments. Firms and industries providing 'unsafe' work environments will face higher labour costs, thus causing them to contract relative to industries providing 'safe' work environments;
- the evidence suggests that wages do reflect differences in job risk (the pay premium is known as a 'compensating variation'). Mears and Chapple (1996) argue that "the balance of North American and UK evidence suggests that compensating variations exist in the labour market";[5]

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3 See, for example: Jacobsen, Veronica (1996), *Risky Business: A Review of Institutional Arrangements for Occupational Health and Safety*, report prepared for the New Zealand Treasury, Wellington; Mears, Tracy and Simon Chapple (1996), *Government Involvement in Health and Safety: A Literature Review*, Department of Labour Occasional Paper 1996/I, Department of Labour, Wellington; and Shapiro, Sydney (1999), *Occupational Health and Safety Regulation*, Encyclopaedia of Law and Economics and Viscusi, W Kip, John M Vernon and Joseph E Harrington Jr (1997), *Economics of Regulation and Antitrust*, 2nd edition, MIT Press, Cambridge, pp 655–709.

4 According to the Cato Institute, in 1993 the chance of dying in an accident at work in the United States was 8/100,000 – slightly below the chance of dying at home (9/100,000) and half the chance of dying in an automobile accident.

5 Mears and Chapple (1996), *op cit*, p 66.

- in some circumstances, market mechanisms may not provide the appropriate amount of workplace health and safety. For example, the incentives for firms to provide safety may be blunted when wage premiums do not reflect actual risks (for example, because of a lack of information on the riskiness of different jobs);
- even if there is market failure (that is, the market is not delivering the appropriate level of workplace health and safety), this does not imply that government intervention is justified. Indeed, government intervention (for example, through regulation) could actually make things worse or achieve workplace safety improvements at such a high cost that the costs of intervening exceed the benefits;
- the government can intervene in different ways. For example, it can regulate, provide information to workers on the riskiness of particular jobs or provide information to firms and workers on good practice in health and safety;
- the nature and design of government regulations is a critical issue. The way in which the government regulates is as important as whether it regulates. Regulations are not all created equal. Indeed, there are significant differences in the cost-effectiveness of various regulations aimed at increasing health and safety. For example, Hahn, Lutter and Viscusi (2000) show that the amount of risk reduction obtained from regulations with a similar cost can vary by as much as 100,000 times;[6] and
- there are a number of mechanisms in addition to the labour market and regulation for handling workplace risk. These include insurance, workers' compensation and tort liability, which interact with the labour market to provide firms with incentives to provide an optimal level of health and safety at work.

5 Comment

5.1 There are many aspects of the HSE Amendment Bill that merit comment. Our objective in this submission is three-fold:

- to provide some broader policy analysis to assist the Committee in its consideration of the Bill;
- to comment on the general policy approach to improving workplace safety that underlies the Bill; and
- to comment on selected specific policy proposals included in the Bill.

5.2 We do not adopt a clause-by-clause analysis of the Bill.

5.3 The HSE Amendment Bill's approach to increasing health and safety in the workplace

5.4 The issue of health and safety in the workplace is an important one. While recent years have seen considerable progress on this front, more remains to be done.

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6 Hahn, Robert W, Randall Lutter and W Kip Viscusi (2000), *Do Federal Regulations Reduce Mortality?*, AEI-Brookings Joint Center for Regulatory Study, Washington, DC, p 3.

5.5 The HSE Amendment Bill proposes an extension of the current approach to health and safety regulation that is broader in terms of coverage and focuses to a much greater degree on regulation, *ex-post* enforcement and penalties.

5.6 The NZBR supports the objective of ensuring the appropriate degree of safety in New Zealand workplaces. We do not support the proposed measures in the HSE Amendment Bill because we think they:

- show insufficient appreciation for the powerful role that market mechanisms can play in increasing workplace health and safety and the significant gains that have been made in workplace safety both prior to, and in the period since, the passage of the HSE Act 1992; and
- are unlikely to achieve the desired objectives of increasing workplace safety or will do so only in a way that is not cost-effective.

5.7 As noted above, there are strong incentives on firms to improve workplace safety. These have led to considerable progress in lifting workplace safety, both in aggregate and for particular industries. Evidence from the United States shows that:

- workplace fatalities dropped from 37 per 100,000 workers in 1933 to 4 per 100,000 workers in 1998. Nearly 60 percent of this decline occurred during the period prior to 1970, when the Occupational Safety and Health Administration (OSHA) was created in the United States;[7] and
- the number of work-related musculoskeletal disorders (MSDs) dropped from 750,000 in 1992 to less than 600,000 in 1997, with an accelerated decline in MSD injuries of 17 percent in the last three years of the reporting period.[8]

5.8 A variety of factors are responsible for recent gains, including structural changes in the economy, new technology and better information.[9]

5.9 Evidence from New Zealand shows a similar trend in workplace health and safety. For example:

- the number of work-related fatal injuries declined from 87 in 1985 to 57 in 1994. Two-thirds of this decline occurred during the period prior to the passage of the HSE Act in 1992.[10] In 2001, the number of fatal accidents attended by OSH stood at 39;[11]
- between 1985 and 1994, the number of work-related deaths fell from 5.7 deaths per 100,000 employees to 3.9 deaths per 100,000 employees, a

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7 Wilson, D Mark (2000), *The Workplace: Enhancing Opportunity, Safety and Innovation*, Chapter 11 of Issues 2000, Heritage Foundation, Washington, DC, p 405.

8 Mahoney, Richard J and Milka S Kirova (2000), *Ergonomics by OSHA … Ergo, Outgo by Business*, CSAB Forum, Number 7, Center for the Study of American Business, Washington University, St Louis, p 2.

9 Vedder, Richard (2000), *Technology and a Safe Workplace*, Policy Study Number 156, Center for the Study of American Business, Washington University, St Louis, p 16.

10 Department of Labour (1999), *Briefing to the Ministers of Accident Insurance, Immigration, Labour and Social Services and Employment*, Wellington.

11 See http://www.osh.govt.nz/hazards/stats/fatals/fatals.html.

decrease of over 30 percent. Since 1975, the decrease has been 51 percent;[12]

- claims for repetitive strain injury (RSI)/occupational overuse syndrome (OOS) fell by 75 percent between 1996 and 1999 as a result of the introduction of early identification and intervention programmes;
- notifiable occupational diseases fell from a peak of nearly 2,000 in 1995/96 to 800 in 1999/2000;[13]
- notifications for occupational overuse syndrome/osteoarthritis dropped by nearly half between 1996 and 1998 – from 828 to 426;[14] and
- in the meat industry, the rate of accidents causing time off work beyond the day of the accident declined from around 30 accidents per 100,000 hours worked during the 1980s to 12.7 accidents per 100,000 hours worked in March 1996, 9.9 accidents per 100,000 hours worked in March 1997 and 6.2 accidents per 100,000 hours worked in March 2000.[15]

5.10 Private firms and industry groups, as well as the private sector more generally, are continuing to take steps to improve health and safety in the workplace. In many cases, these initiatives are undertaken in partnership with the Accident Compensation Corporation (ACC). For example:

- the Meat Industry Association (MIA) has conducted the Lost Time Injury Frequency Rate Survey (LTIFRS) for more than 20 years. The LTIFRS provides a benchmarking tool for meat companies to gauge performance on safety issues. Similar benchmarking tools have now been adopted by other industries, including dairy;
- the MIA is also undertaking a number of projects, in cooperation with the Meat Industry Research Institute of New Zealand, to reduce accidents in the industry. Many of these initiatives are small but reports suggest that they are achieving excellent results; and
- Safeguard Publishing publishes a magazine and newsletter that explore New Zealand health and safety issues, including product and service reviews;
- the New Zealand Forest Industries Council/New Zealand Forest Owners Association, with the financial support of ACC, have undertaken initiatives such as the *Alcohol and Drug Free Workplace Programme* (October 2000). Other industries are said to be considering using the materials from this programme; and
- the Wellington telephone book lists some 15 safety consultants providing a range of safety services and equipment to firms.

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12 Occupational Safety and Health Service (1999), *No Room for Complacency after Drop in Workplace Deaths*, Department of Labour, Wellington.

13 Occupational Safety and Health Service (2001), *Report on the Notifiable Occupational Disease System*, Department of Labour, Wellington, p 9.

14 Statistics New Zealand (2000), *The Occupational Safety and Health Service: Ratonga Oranga*, http://www.stats.govt.nz.

15 Meat Industry Association Annual Report 2000, p 14.

5.11 These are only a few of the ways the private sector is working to increase health and safety in the workplace. Many other initiatives are underway across a range of industries, including fishing, forestry, meat, construction and road transport.

5.12 It should not be surprising that the private sector works actively to increase workplace health and safety. Firms have much to gain from these improvements. As noted by Kniesner and Leeth (2001):

> Market forces also promote worker safety and health. Empirical studies show wages rising with workplace risk. All else being equal, the typical American worker in a job with a likelihood of injury earns, on average, 2 to 4 percent more than a person working in a safer job. The added compensation firms must pay to workers who accept more hazardous work is an incentive for firms to expand their investments in safety programs. Firms weigh the benefits of improved safety – smaller compensating wage premiums, lower costs of purchasing workers' compensation insurance, fewer work stoppages, and smaller fines for possibly violating OSHA health and safety standards – against the costs of expanded safety programs.[16]

5.13 Also in a US context, Vedder (2000) cites evidence that moderately risky jobs pay around 10 percent more than so-called risk-free or low-risk jobs.[17] Viscusi notes that firefighters in Kuwait during the Gulf War were paid US$500,000 per annum, while elephant handlers at the Philadelphia Zoo receive additional annual compensation of US$1,000 because of the risk of injury.[18]

5.14 The existence of compensating wage differentials creates a strong incentive for employers to take care – as long as the cost of doing so is offset by the gains from lower wage costs and a lower employee turnover rate. In a competitive market such measures will reduce an employer's insurance premia.[19] Employers will not necessarily choose to eliminate workplace risk, even if this were possible without ceasing operation. Indeed, depending on worker preferences for higher wages, the optimal level of risk could be very high in the riskiest industries.

5.15 The combined effect of labour market incentives in the form of compensating wage differentials, insurance and non-regulatory instruments such as workers' compensation is likely to be much greater than the effect of regulation on workplace safety and health. This is because the total amount spent on fines and on OSH enforcement is very small relative to wage premiums and workers' compensation. For example, compensating wage differentials and workers' compensation payments in the United States amounted to over

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16 Kniesner, Thomas J and John D Leeth (2001), *Occupational Safety and Health Administration, in Cato Handbook for Congress: Policy Recommendations for the 107th Congress*, Cato Institute, Washington, DC, p 416.

17 Vedder, *op cit*, p 2.

18 Viscusi, W Kip (1992), *Fatal Tradeoffs: Public and Private Responsibilities for Risk*, Oxford University Press, New York, p 6.

19 Viscusi, *et al*, *loc cit*.

US$260 billion in 1998, compared with only US$132 million levied in fines during that year. As Kniesner and Leeth (2001) comment:

> The ratio of those costs – nearly 2,000 to 1 – makes the economic incentives to improve safety by reducing compensating wage differentials and workers' compensation insurance expenses far greater than the safety-enhancing incentives of the relatively small fines imposed by OSHA for violating its standards.[20]

5.16 The US experience with OSHA and other countries' experience with occupational health and safety regulation suggest that efforts to improve workplace safety through greater regulation are unlikely to bear fruit or will achieve gains only at a much higher cost than is necessary. A number of studies report only mixed results from efforts to increase workplace safety through greater regulation. For example:

- Smith (1976) found that actual injury rates were not significantly lower than predicted injury rates in high hazard industries that were targeted for enforcement by OSHA;[21]
- Mendeloff (1980) found that OSHA did have an impact for some types of injuries in California, but that it had no impact on the aggregate injury rate for California and the nation;[22]
- Vedder (2000) argues that "summing up the historical evidence, the trends seem to suggest that, in the absence of OSHA and similar agencies, workplace safety would probably be similar to what is actually observed. The benefits of regulation, if any, are comparatively small. However, the costs are considerable";[23]
- Scholz and Gray (1990) found that the threat of fines and inspections had a small, but significant, impact on workplace injury rates. They also found that increasing the number of inspections is far more effective than a comparable increase in average penalty value.[24] Gray and Jones (1991) found similar evidence, with inspected firms exhibiting a significant reduction in hazards;[25]
- Lanoie (1992) found that safety regulation had only a minor impact on accident frequency;[26] and
- Mears and Chapple (1996) review a range of studies on the impact of occupational health and safety. They conclude that "perhaps the strongest conclusion comes regarding regulations. US and Canadian

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20 Knieser and Leeth, *loc cit*, p 416.

21 Smith, Robert S (1976), *The Occupational Safety and Health Act: Its Goals and its Achievements*, American Enterprise Institute, Washington, DC.

22 Mendeloff, John M (1980), *An Economic and Political Analysis of Occupational Safety and Health*, MIT Press, Cambridge, MA.

23 Vedder, *op cit*, p 7.

24 Scholz, John and Wayne Gray (1990), 'OSHA Enforcement and Workplace Injuries: A Behavioural Approach to Risk Assessment', *Journal of Risk and Uncertainty*, Vol 3, pp 283–305.

25 Gray, Wayne and Carol Jones (1991), 'Are OSHA Health Inspections Effective? A Longitudinal Study in the Manufacturing Sector', *Review of Economics and Statistics*, 73 (3), pp 504–512.

26 Lanoie, Paul (1992), 'The Impact of Occupational Safety and Health Regulation on the Risk of Workplace Accidents: Quebec, 1983–1987', *Journal of Human Resources*, Vol 27, pp 643–660.

evidence suggests that health and safety regulations have little or no significant direct impact on safety, let alone meet cost-benefit criteria".[27]

5.17 As noted above, the evidence on the impact of increased regulation on workplace safety is mixed. This means that the proposed changes in the HSE Amendment Bill, which rely principally on greater regulation and *ex-post* enforcement, are unlikely to have a major impact on workplace safety. Furthermore, the proposed changes could actually reduce safety if they adversely affect New Zealand's growth rate. This is because the key driver of greater health and safety generally is increasing income ('wealthier is healthier').[28] Growth and safety are complements, not substitutes.

5.18 While a small minority of firms may expose their employees to undue risks, that is not a reason to impost excessive costs on the great majority of firms that take all reasonable steps to maintain a safe working environment. Occasional mistakes, sometime with tragic consequences, will occur no matter how demanding the regulatory regime. The appropriate approach is to focus on those who breach safety standards by applying the existing criminal and other law.

5.19 The HSE Amendment Bill represents another example of government regulating interactions between consenting private individuals without any analysis or evidence being presented that demonstrates the superiority of legislation over the common law.

5.20 As noted in Wilkinson (2001), there have been many encroachments by legislation on the common law, often with detrimental effects.[29] Kirk (1992) recently commented on the trend for statute law to displace the common law as follows:

> In the twentieth century, the common law of England, of the United States, and indeed of every country that has adapted English common law 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.[30]

5.21 Additional compliance costs

5.22 A general concern with the HSE Amendment Bill is that many of the changes will increase compliance costs for business while doing little, if anything, to improve occupational health and safety. For example:

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27 Mears and Chapple, *op cit*, p 66.

28 Hahn, *et al*, *loc cit*

29 Wilkinson, Bryce (2001), *Constraining Government Regulation*, New Zealand Business Roundtable, Federated Farmers of New Zealand Inc, Auckland Regional Chamber of Commerce and Industry and Wellington Regional Chamber of Commerce.

30 Kirk, Russell (1992), *The Roots of American Order*, 3rd edition, Regnery Gateway Publishing, Washington, DC, cited in Wilkinson (2001).

- the introduction of what is effectively mandatory employee participation in occupational health and safety, together with the power given to (union) safety representatives to issue 'hazard notices'; and
- allowing parties other than the statutory authority to take prosecutions. This step opens the way for actions based on a variety of motives. Although such prosecutions may have little chance of success, they would impose significant legal costs and loss of management time on employers.

5.23 As is noted at several points in this submission, these compliance costs will be amplified by existing uncertainties in the HSE Act 1992, including the requirement that employers take 'all practicable steps' to ensure safety.

5.24 These additional compliance costs come on top of those already introduced by the government, estimated by Business New Zealand to be in excess of $26,000 for a medium-sized business.[31]

5.25 Extension of definition of 'harm' and 'hazard' to include 'stress'

5.26 The NZBR is extremely concerned that the HSE Amendment Bill proposes to widen the definition of 'harm' and 'hazard' to include 'stress'. The inclusion of stress risks creating a relatively open-ended liability because:

- stress is not well defined and is in fact very difficult to define. It is therefore more susceptible to fraudulent claims that physical injuries;
- there is considerable variation in individual susceptibility to stress; and
- stress often has its roots in personal problems outside work.

5.27 The open-ended nature of this liability in the HSE Amendment Bill contrasts with the provisions of workplace legislation in other jurisdictions, which are much more limited in scope. For example, workplace legislation in Queensland and South Australia requires proof that the job was a 'substantial' cause of the disability and that the disability did not arise predominantly from reasonable management action by the employer.[32]

5.28 As currently drafted, the inclusion of stress would greatly increase uncertainty for employers and could result in employers bearing responsibility for illnesses that were not caused by work circumstances at all. This will amplify the uncertainties that already exist in the HSE Act 1992 as a result of the ill-defined and open-ended requirement that employers take "all practicable steps" to ensure safety. Experience with claims to ACC for pain and suffering illustrates the risks involved.

5.29 A second concern is that the inclusion of stress in the HSE Amendment Bill and giving unions and employees the right to issue hazard notices and bring actions against employers, invites people to abuse safety legislation for industrial purposes. This suspicion is reinforced by the comments of the minister of labour in the *New Zealand Herald* on 11 February where she is quoted as citing the financial services industry as one where:

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31 Business New Zealand (2002), The Great NZ 7 Day Service Co. Ltd', Press Release, 25 February.

32 Muir, Philippa, 'Dialogue: Stress bill hazardous for business', *New Zealand Herald*, 12 February 2002.

> "People are being set performance targets which keep on changing". Employers may claim that performance targets are an essential part of the industry, but the goals have to be achievable. "That's where the consultation comes in, and that's where I'm hoping that we can set up codes within those industries where there are particular issues."[33]

5.30 This concern will be exacerbated by the fact that health and safety representatives will be elected. The election process will provide unions with a vehicle to use this role as a tool for pursuing industrial agendas, thus raising compliance costs and removing the focus of management from running a successful business. For example, in the financial services industry, Finsec would like a greater say in how work is organised – especially in the setting of performance targets and pay. Leaving the detail out of the HSE Amendment Bill so that it can be decided in consultation with employee representatives will encourage the union to use OSH legislation to advance their industrial objectives. Indeed, the minister's comments suggest that this is exactly what is envisaged.

5.31 Removal of ability to insure against fines

5.32 The HSE Amendment Bill makes it unlawful to insure against fines issued under the Act, although insurance for the cost of defending a prosecution remains lawful. As noted by Campbell (2002), the proposal appears to be based on two premises:

- that allowing insurance against OSH fines is tantamount to allowing persons to contract out of their obligations under the HSE Act 1992; and
- that insurance removes or significantly reduces any incentive to comply with the HSE Act 1992.[34]

5.33 Campbell dismisses both of these arguments, noting that "[T]hese rather opaque claims reflect a surprising misunderstanding of the effect that insurance has in relation to obligations under legislation such as the Health and Safety in Employment (HSE) Act". He argues that, contrary to what the HSE Amendment Bill's drafters appear to believe, insurance does not allow employers to contract out of the HSE Act 1992, nor does it reduce, to any significant extent, their incentive to comply with the HSE Act 1992.[35]

5.34 While the benefits of this provision may be minimal, the costs are likely to be high given that they will significantly increase uncertainty for employers. Once again, this uncertainty will be amplified by the existing design of the HSE Act 1992, which already creates considerable uncertainty.

5.35 Quality of policy advice

5.36 An issue of significant concern to the NZBR is the poor quality analysis that is displayed in the Cabinet papers underlying the HSE Amendment Bill. The

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33 Taylor, Kevin, 'Stress claims must be proved', *New Zealand Herald*, 11 February 2002.

34 Campbell, Neil (2002), 'Editorial: Insuring against OSH fines', *Company and Securities Law Bulletin*, p 133.

35 *Ibid*.

Regulatory Impact and Compliance Cost Statements attached to the individual Cabinet papers do not meet even the most minimal tests for good quality policy advice. In general, the papers:

- are not underpinned by a rigorous analytical framework;
- are weak on problem definition;
- provide only a cursory analysis of the proposed measures and little discussion of alternatives that would meet whatever objectives are being sought by the policy changes;
- contain little or no assessment of the potential benefits and costs of the proposed measures. In many cases, the stated rationale for adopting a particular measure is that it received "support from submissions on the Discussion Paper";[36] and
- make no attempt to quantify the potential benefits and costs of the proposed measures in terms of lives saved, reduced injuries, costs imposed on business, and so on.[37]

5.37 For example, the Cabinet paper entitled *Changes to the Health and Safety in Employment Act: Effective Enforcement Paper* states that "increasing the certainty of detection and the severity of punishment under the HSE Act will improve compliance …" In fact, as outlined in paragraph 5.16 above, the evidence on this issue is not nearly as clear-cut as is implied by this statement. A comprehensive review of the evidence on this particular issue was readily available on the Department of Labour's own website.

5.38 The weakness of the analytical base that is used to support these changes is of particular concern given the importance of the issues being addressed and the potential adverse impacts on business of the proposed changes for what would appear to be little gain in terms of increased safety. It is also of particular concern given that the Ministerial Panel on Business Compliance Costs had noted the concerns of business with respect to the HSE Amendment Bill.[38]

5.39 The poor quality policy process contrasts with the processes used in other countries such as the United States. For example, OSHA's proposed introduction of an ergonomics standard underwent extensive analysis and even this was criticised as insufficient. The process included a full economic analysis by OSHA, review by the Small Business Administration and the General Accounting Office and several quantifiable cost-benefit analyses by both government and non-government researchers.[39] As a result of this process, the proposed standard was withdrawn. It is important to highlight that the changes in the HSE Amendment Bill are much more comprehensive

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36 For example, this is the stated rationale for banning insurance against fines under the HSE Act 1992.

37 For a more comprehensive critique of the quality of the Regulatory Impact Statement, see Capital Economics (2001), *Assessment of the Health and Safety in Employment Bill: Regulatory Impact Statement*, Draft Paper, Capital Economics, Wellington.

38 Ministerial Panel on Business Compliance Costs (2001), *Finding the Balance: Maximising Compliance at Minimum Cost*, p 6.

39 See, for example, Employment Policy Foundation (2000), *Critique of OSHA's Economic and Regulatory Flexibility Analysis of the Proposed Ergonomics Program Standard*, Employment Policy Foundation, Washington, DC and Mahoney and Milka, *loc cit.*

than what was proposed in the United States, yet they appear to have received little or no quality analysis.

5.40 Given the potential impact of the HSE Amendment Bill, it is crucial that the policy proposal undergo much more rigorous independent scrutiny.

6 Conclusion

6.1 The issue of health and safety in the workplace is clearly an important one. Considerable progress has been made in recent years in reducing accidents, illness and death in New Zealand workplaces. But more remains to be done. The NZBR is concerned to ensure that there is the appropriate amount of safety in New Zealand workplaces. From its perspective, the HSE Amendment Bill's objective of improving health and safety in the workplace is not at issue. However, there are difficult trade-offs in the achievement of health and safety.

6.2 In the end, the HSE Amendment Bill cannot be judged on its objectives. It has to be judged on whether or not its benefits exceed its costs. In our view, the HSE Amendment Bill fails this test. In particular, we believe that the proposed measures are unlikely to improve health and safety significantly in the workplace and could in fact make things worse if they lower economic growth. Furthermore, even if the proposed measures do increase workplace health and safety, these gains will come at a much higher cost than if alternative measures were adopted. In other words, a different set of policies would allow more lives to be saved and reduce workplace illness and injury by more than would be achieved under the proposed measures at the same lower cost to society. This is of significant concern because it means that resources that could have contributed to the betterment of New Zealand society are being thrown away.

6.3 Achieving health and safety in the workplace involves a complex mix of environmental factors, equipment and individual actions. Available evidence suggests that health and safety in the workplace can best be achieved by the following:

- the implementation of sound strategy to raise economic growth. Citizens of countries with the highest per capita incomes are among the healthiest. High-income countries also have more choices when it comes to spending on safety and health and other activities;[40]
- well-functioning labour markets that compensate workers *ex ante* for job risks and force employers to compete against other employers for available labour. The employer's safety record is a factor in such competition;
- *ex-post* compensation for injuries or illness through appropriately designed workers' compensation schemes and/or tort law. The deficiencies of tort law in New Zealand will, other things being equal, lead to more deaths and more injuries in New Zealand workplaces; and
- appropriately designed regulatory interventions.[41]

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40 Hahn, *et al*, *loc cit*.

41 Shapiro, *op cit*, p 620.

6.4 Regulations differ significantly in terms of their effectiveness and their performance on a cost-benefit basis. It is therefore very important to 'get it right' when new regulations are introduced.

6.5 In our view, the HSE Amendment Bill is flawed because it places too little emphasis on the first three of the elements noted in paragraph 6.3 and includes a number of poorly designed regulatory interventions. In particular:

- the benefits of increased regulation and a greater OSH presence, in terms of increased safety in the workplace, are unproven;
- they will make the HSE regulatory environment more uncertain by introducing coverage in areas such as mobile workers and stress and fatigue;
- the changes will add significantly to the regulatory burden on all businesses and particularly on small businesses, thus inhibiting their scope to grow and innovate;
- to the extent that these changes adversely affect economic growth, they could reduce health and safety in the workplace, given that a major driver of safety is higher national income;
- changes to the HSE Act 1992 are being introduced as a means of overcoming what may be weaknesses in other parts of the regulatory framework for health and safety, including the accident compensation scheme and tort law; and
- there is a considerable risk that the new OSH rules will become a tool for unions to use to control work processes, notwithstanding the fact that strict liability applies to employers for any contraventions of the statute.

6.6 There are already significant concerns with the existing HSE Act 1992.[42] The changes proposed in the HSE Amendment Bill are likely to make the position worse. The net costs of the proposed OSH changes are potentially significant in terms of reduced competitiveness and higher compliance costs for New Zealand businesses.

6.7 The government has made an ambitious commitment to restore New Zealand to the top half of the Organisation for Economic Cooperation and Development (OECD) income rankings. The issue of economic growth is also top of mind for many New Zealanders. A recent UMR Research survey carried out for Business New Zealand, the Knowledge Wave Trust and the Science and Innovation Advisory Council showed that, of those surveyed:

- only 21 percent felt that the economy was performing well enough to deliver enough high quality jobs and quality health, education and other social services; and
- 83 percent felt that growing the economy was the best way to deliver more quality jobs, better health care, education and other social services.

42 See Wilkinson, *op cit*, pp 28–33 and Ministerial Panel on Business Compliance Costs, *op cit*, pp 73–78.

6.8 Yet, New Zealand's growth performance has been deteriorating, not improving, in recent years.[43] The HSE Amendment Bill changes will do nothing to help the government meet these ambitious growth targets. Indeed, they are very likely to move us further away from achieving them.

7 Recommendations

7.1 The NZBR opposes the measures outlined in the HSE Amendment Bill and recommends that it should not proceed. Instead, we recommend:

- a high quality independent review of the design of the existing HSE Act 1992 and possible options for addressing existing shortcomings. This should include research aimed at building up the research base on health and safety issues, including assessing available evidence on what works and what does not work in promoting workplace health and safety;
- facilitate the dissemination of information on best practice in workplace health and safety. New Zealand's experience in recent years is that industries can and do learn a lot from one another about ways of improving workplace health and safety;
- consider health and safety objectives within a wider policy framework, including accident compensation and tort reform.[44] Both of these can have an impact on health and safety by improving incentives to take care. To the extent that these policy settings are wrong, OSH policy is being asked to make up for their deficiencies. For instance, fines, private prosecutions and exemplary damages can be seen as attempts to skirt around the weaknesses of the no-fault principle; and
- examine possible initiatives to improve the policy-making process. Despite the potential significance of the workplace health and safety changes, the analysis underpinning the proposals is not at all rigorous. Workers, taxpayers and businesses deserve better. One possibility is to consider the introduction of a regulatory responsibility act, as discussed in Wilkinson (2001).[45]

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43 Kerr, Roger (2002), *Agenda 2002: An Election with Vision*, Speech to Rotary Club of Wanganui, New Zealand Business Roundtable, 28 January.

44 Credit Suisse First Boston (1998), *Accident Compensation: Options for Reform*, New Zealand Business Roundtable, Wellington.

45 Wilkinson, *op cit*.

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE PARENTAL LEAVE AND EMPLOYMENT PROTECTION (PAID PARENTAL LEAVE) AMENDMENT BILL

FEBRUARY 2002

1 **Introduction**

1.1 This submission on the Parental Leave and Employment Protection (Paid Parental Leave) Amendment Bill (PPL Bill) 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.

2.0 **Key elements of the PPL Bill**

2.1 The key elements of the PPL Bill are as follows:

- Parents who have been in paid employment with a single employer for 10 or more hours per week for a full year before the birth/adoption of a child will be eligible to claim the payment.
- The benefit payable is equal to $325 gross per week or 100 percent of previous weekly earnings, whichever is lower.
- Payment will be provided for 12 weeks and can be shared between eligible partners, including those in same-sex relationships.
- The scheme will be funded from general taxation.
- The scheme comes into effect on 1 July 2002.
- Parents benefiting from PPL do not have to return to work at the end of the 12-week payment period.

3.0 **Comment**

3.1 The NZBR does not support the proposed PPL Bill. There are a number of reasons for this. These are discussed below.

3.2 Proponents often justify the introduction of PPL on the basis that New Zealand is one of only three of the member countries of the Organisation for Economic Cooperation and Development (OECD) (the United States and Australia being the others) without such paid leave. This ignores the important point that most of the countries cited (for example, Sweden, Canada, France, United Kingdom) have a much higher standard of living than New Zealand and hence are much more able to 'afford' more extensive social benefits. While being wealthier does not necessarily justify the payment of tax-financed parental benefits, it is nonetheless the case that New Zealand cannot expect to have a 'first world' social policy lifestyle on a 'second world' standard of living. It is only through a growing economy that New Zealand will be able to afford higher social spending, where such spending is justified.

3.3 The New Zealand labour market has changed considerably in recent decades, with an increasingly diverse workforce, a significant increase in the labour force participation rate of women and an increasing proportion of the workforce engaged in so-called 'non-standard' work, such as part-time work and self-employment.

3.3 The deregulation of the labour market in 1991 through the introduction of the Employment Contracts Act (ECA) recognised the changing realities of the labour market. It did so by putting in place a regime under which employees and employers were free to negotiate mutually beneficial employment arrangements, including non-wage benefits such as parental benefits, health benefits or holiday entitlements.

3.4 The NZBR strongly supports the continuation of such a system for regulating employment relationships and the right of employees and employers to negotiate paid parental leave where this is deemed to be mutually beneficial. In our view, a flexible and voluntary system of negotiation over the terms and conditions of employment contracts is the best way of recognising the differing circumstances and preferences of employees and firms and ensuring that the labour market is able to evolve appropriately.

3.5 In many cases, New Zealand employees and employers have negotiated paid parental leave provisions as part of their contracts. According to the Equal Employment Opportunities (EEO) Trust, estimates of the proportion of firms offering employer-funded PPL vary from 13 percent to 43 percent. Currently, 35 percent of employees have some form of PPL in their contracts.[1] However, more than 10 years after the deregulation of the labour market, PPL is still not a condition of a majority of contracts. This suggests that most employees and employers feel that the provision is less mutually beneficial than other conditions of employment. Effectively, in contracts that include PPL, employees willingly forgo some element of wages or other benefits for paid leave. Less skilled – and hence lower paid – workers in particular are more likely to prefer higher wage rates than a lower wage/parental leave trade-off.

3.6 In our view, the blanket provision of taxpayer-funded paid parental leave as proposed in the PPL Bill is inconsistent with a flexible, voluntary and forward-looking employment contracting system because it overrides the preferences of those directly involved in the employment relationship, namely employees and employers. In our view, parental leave arrangements should be a matter to be freely determined by the parties directly involved, rather than being determined centrally.

3.7 One of the most common arguments advanced is that PPL can lead to improved labour market outcomes for women and greater gender equity in the labour market. These improved labour market outcomes are thought to arise because access to parental leave allows women (who are the principal users) to:

- maintain their association with a particular firm after childbirth, thus retaining the 'firm-specific' human capital they have built up; and
- retain a good job match, which might otherwise be broken if they were to leave the labour force as a result of pregnancy.

From an employer's point of view, parental benefits may offer a cost-effective way of attracting and retaining skilled staff.[2]

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1 *Background to Paid Parental Leave*, Equal Employment Opportunities Trust, Auckland, http://www.eeotrust.org.nz.

2 *The Business Benefits of Work and Life*, Equal Employment Opportunities Trust, Auckland, http://www.eeotrust.org.nz.

3.8 Parental leave may also provide benefits by allowing parents to spend more time with their children during the initial months after childbirth, which can improve outcomes for both parents and children. In a recent cross-country study, Ruhm (1998) found that rights to parental leave were associated with substantial decreases in paediatric mortality.[3]

3.9 Despite the above, the case for parental benefits is not clear-cut. Indeed, the existing literature on the issue suggests that the labour market and social effects of parental leave are complex and uncertain. There are many reasons for this:

- Many of the identified gains would accrue under a system of unpaid mandated leave. The provision of paid leave will only improve these gains to the extent that it encourages additional workers to take leave.
- The size of the benefits from increased job attachment is unknown. In a recent study, Erosa, Fuster and Restuccia (2001) argue that the gains accruing from increased job attachment are small and that parental leave policies lead to aggregate welfare losses.[4]
- Many of the gains are captured by workers themselves, rather than by society as a whole and hence do not provide any justification for public subsidy. These gains can be internalised through contracting between employees and employers.
- Gains from better job matching may be offset by the 'same employer' requirement in the PPL Bill if workers stay in an 'unsuitable' job for a longer period than they would otherwise, in order to qualify for paid parental leave.
- The literature suggests that short periods of parental leave may increase women's labour force attachment and wages, but that extended periods of parental leave may do the opposite, especially where leave is paid. For example, Ruhm (1998) found that mandated short leaves had only a minor impact on wages, but long duration leaves were associated with large reductions in female wages.[5]

3.10 Given the last point above, the economic costs of the policy, even if small now, could grow over time as PPL expands in response to further political pressure. This would appear to be a very real risk, with the Hon Laila Harré already indicating that "… [T]his … scheme should be seen as a good starting point. It's now up to New Zealanders to decide how it can best be expanded, and how this should be paid for".[6] The Canadian experience, which has seen the entitlement for maternity/parental benefits expand from 15 weeks to 50 weeks since their inception in 1971, is salutary.

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3 Ruhm, C (1998), *Parental Leave and Child Health*, NBER Working Paper 6554, National Bureau of Economic Research, Cambridge.

4 Erosa, Andres, Luisa Fuster and Diego Restuccia (2001), *A General Equilibrium Analysis of Parental Leave Policies*, Macroeconomic Perspectives on Families and Inequality: Conference Proceedings, New York University, September.

5 Ruhm, C (1998), 'The Economic Consequences of Parental Leave Mandates: Lessons from Europe', *Quarterly Journal of Economics*, pp 285–317.

6 Harré, Hon Laila (2001), 'Paid Parental Leave – a great start', Press Release, Government of New Zealand, Wellington, 7 November.

3.11 The introduction of PPL will lead to a worsening in the environment for doing business in New Zealand. There are at least four reasons for this:

- It will require taxation to be higher than would otherwise be the case. Businesses and taxpayers generally will have to pay additional taxes to finance the scheme. In addition, the size of the scheme is likely to grow over time and cost more than expected as potential beneficiaries adjust their work patterns to meet the programme's eligibility requirements and as a result of pressure for expansion.
- The introduction of PPL will add further rigidities to the labour market, thus limiting labour market adjustment and reducing New Zealand's attractiveness as an investment destination.
- To the extent that PPL increases leave-taking, employers will be faced with the increased costs associated with keeping claimants' jobs open and finding replacement workers during leave periods. This will be particularly burdensome for smaller businesses and in areas where individuals have specialist skills. The tight job market that currently exists is likely to exacerbate these costs for firms.
- PPL will lead to greater administration costs. Much of the administrative detail will be included in later regulations and will not be subject to the select committee process. We commend the submission of Business New Zealand to the Committee's attention on these aspects.

3.12 On its own, the impact of PPL on the business climate may not be large. However, it needs to be seen in the context of a number of recent and proposed government initiatives that have adversely affected the operating environment for business in New Zealand, including the renationalisation of accident compensation, the increased regulation of the labour market through the introduction in 2000 of the Employment Relations Act, successive increases in minimum wages, especially for people under 21 years of age, and the proposed changes to the Holidays Act 1981 and occupational, safety and health (OSH) legislation. These impacts will be much greater for small business, which employs nearly one-third of all New Zealanders.

3.13 The introduction of PPL will see groups such as single individuals, the self-employed, childless couples, older people, and single earner families subsidising the lifestyle choice of two-earner families. There seems to be little justification for this on equity grounds. Paid parental leave is unlikely to improve the targeting of government spending toward people on low incomes given that it will benefit predominantly two-earner families and will not be means tested.

3.14 Paid parental leave is also subject to criticism on social grounds. On the one hand, it can be seen as an extension of the benefit system. Patricia Morgan, in a forthcoming book for the NZBR, argues that, despite good intentions, the domestic purposes benefit, child support and similar arrangements have weakened the acceptance of personal responsibility for the care and support of children and encouraged welfare dependency and lifestyles, such as sole parenthood, that are, on average harmful to children.[7] Paid parental leave can

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7 Morgan, Patricia (forthcoming), *Farewell to the Family in New Zealand?*, New Zealand Business Roundtable, Wellington.

be seen as a further step along the road in which the state progressively assumes roles that should be performed by parents. Rather than extending the benefit system, the broad direction of policy should be to strengthen families by promoting economic growth and higher household incomes, reducing government expenditure and taxes, and allowing people greater scope to use their after-tax income on private activities including the support of their children.

3.15 On the other hand, the introduction of PPL can be seen as having an adverse impact on gender equity to the extent that it reinforces traditional gender roles in the family and helps to perpetuate differences in labour market outcomes for men and women. This is a real risk given that parental leave tends to be taken disproportionately by women.[8] For example, Blau and Ehrenberg (1997) cite the extensive leave provisions in Germany, noting that "rather than facilitating women's attachment to work, such a policy seems virtually an invitation to their retaining a traditional role within the family".[9] Indeed, one of the intentions of maternity policies in European countries has been to encourage women of childbearing age to leave the labour force, because women were viewed primarily as caregivers, rather than workers.[10]

4.0 Conclusion

4.1 The NZBR strongly supports the ability of employees and employers to continue to negotiate mutually beneficial terms and conditions in their individual or collective contracts. However, for the reasons outlined in this submission, we do not support the introduction of tax-funded mandatory paid parental leave. We have identified a number of concerns with the proposal:

- The potential labour market benefits of PPL are complex and uncertain.
- Paid parental leave is likely to have an adverse impact on the business climate in New Zealand. This will affect business generally and small businesses in particular.
- Spending on the PPL scheme is likely to grow over time and cost more than expected as potential beneficiaries adjust work patterns to meet eligibility requirements, and as a result of pressure for expansion.
- Paid parental leave will have adverse consequences for equity and families.

4.2 The government has made an ambitious commitment to restore New Zealand to the top half of the Organisation for Economic Cooperation and Development (OECD) income rankings. Economic growth is also a priority for many New Zealanders. A recent UMR Research survey carried out for Business New Zealand, the Knowledge Wave Trust and the Science and Innovation Advisory Council showed that, of those surveyed:

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8 Under the Canadian scheme, 95 percent of those claiming biological parental benefits in 1999/00 were women.

9 Blau, Francine and Ronald Ehrenberg (1997), *Gender and Family Issues in the Workplace*, Russell Sage Foundation, New York City, p 4.

10 Forssen, K and Mia Hakovirta (2001), 'Family Policy, Work Incentives and Employment of Mothers', in Sigg, R (ed), *Social Security in the Global Village*, New Brunswick.

- twenty-one percent felt that the economy was not performing well enough to deliver enough high quality jobs and quality health, education and other social services; and
- eighty-three percent felt that growing the economy was the best way to deliver more quality jobs, better health care, education and other social services.

However, since around 1996, New Zealand's growth performance has been deteriorating, not improving.[11] The only way to finance improved social policies and generate higher quality jobs is to increase the country's growth rate.

4.3 One of the key tests of any government policy proposal should therefore be whether or not it makes a cost-effective contribution to increasing New Zealand's long-run rate of economic growth. Clearly, paid parental leave fails this test. Indeed, it is likely to have the opposite effect. This is particularly true given that it comes on top of a series of recent anti-growth policy changes that will make it more difficult for businesses to innovate and grow.

4.4 For the above reasons, the NZBR opposes the introduction of PPL and recommends that the PPL Bill not proceed.

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11 Kerr, Roger (2002), *Agenda 2002: An Election with Vision*, Speech to Rotary Club of Wanganui, New Zealand Business Roundtable, 28 January.

NATIONAL PARTY EDUCATION FORUM

CHOICE AND COMPETITION: RECLAIMING THE EDUCTION REFORM AGENDA IN NEW ZEALAND

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AUCKLAND
21 SEPTEMBER 2001

Summary

- During the 1990s, New Zealand education policy was generally on the right track. The period saw the introduction of many world-leading policies, including greater self-management for schools, a more neutral regulatory environment between public and private providers, the introduction of tertiary tuition fees and the student loan scheme.
- Since late 1999, there has been considerable policy backsliding. A key theme underlying these changes has been a move toward central decree, rather than student and parental choice, as the key mechanism for allocating resources in the education sector.
- Much of the rhetoric today is anti-competition in the education sector. However, this anti-competition bias is rarely, if ever, backed up by any evidence or justification. This is despite the fact there is considerable evidence that competition can be a powerful tool in helping to meet economic and social policy objectives. This is true in education as much as in other areas of the economy.
- Choice policies come in many forms, including vouchers, tax credits, charter schools, private for-profit higher education institutions and private management of public schools. The move toward making greater use of choice and competition in education is picking up steam in the United States, Canada and the United Kingdom. School choice policies have been in place for many years in countries such as Ireland, Denmark, Sweden and the Netherlands.
- International trends make it clear that New Zealand is being left behind other countries in terms of the introduction of sound policies built around choice and competition.
- Three concerns are discussed regarding choice and competition in education. First, choice-based policies are often painted as being 'right-wing'. This is wrong. Pro-choice policies are not a partisan issue. So-called 'centre-left' governments such as the Blair government in the United Kingdom have been leaders in introducing innovative choice-based policies. Second, teachers need not oppose greater choice and competition. There is reason to believe it would benefit good teachers and the profession. Finally, greater choice and competition would not simply serve the interests of the well-off, as is often argued. They already have choice. It is the disadvantaged who have limited choices under a centralised system.
- There is a role for government in education. But we need a much more accommodating and flexible approach to regulating the sector. We need to be clear on what governments should do and what parents and students should do. Governments should reinforce the operation of markets, not supplant it.
- Future reforms at the school level need to go well beyond simply the return of bulk funding, the elimination of zoning and the reinstatement of the Targeted Individual Entitlement (TIE). Much more fundamental changes are needed. Worldwide reforms provide many examples that can be examined and adapted.
- At the tertiary level, it will be important to ensure that policies are built for the long term. Undoing some of the post-December 1999 reforms would be a good start. But here again, much more needs to be done – nobody believed the policy settings were perfect prior to December 1999. The tertiary education

policy platform needs to be built on real analysis, not slogans or pressure from vested interests.

Introduction

Thank you for the invitation to address the National Party Education Policy Forum. It is a pleasure to be asked to contribute to the National Party's deliberations in this critical policy area. I would like to:

- provide a quick overview of education reforms pre- and post-December 1999 and a critique of recent education policy changes;
- discuss international developments in the area of choice and competition in education;
- discuss the implications of these international developments for the design of the National Party education policy platform; and
- discuss a number of general points regarding the government's role in the education sector, including some issues related to marketing the platform.

As you will see, the issues of parental choice and competition will underlie much of the discussion in this speech. The focus is on the school and tertiary education levels, although the arguments remain valid at the early childhood level as well. Indeed, in terms of policy design, the early childhood sector is well ahead of the school sector. The risk is that it will be made to look more like the school sector.

The road we have travelled

For at least 10 years, New Zealand education policy has, in my view, been generally on the right track. From the time of the *Tomorrow's Schools* and *Learning for Life* reforms in the late 1980s, good progress was being made on a number of key policy fronts:

- schools and tertiary institutions were becoming more self-managing;
- students and families were being given more choice in their educational decisions and education funding policies were becoming increasingly demand-driven;
- funding and regulatory policies were generally becoming more neutral – with public and private providers treated in a more even-handed way;
- students at the tertiary education level were being asked to make a modest contribution towards the cost of their tertiary education; 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.

Many of the policies introduced by successive Labour, National and National/New Zealand First governments were regarded as among the best in the world. These include the student loan scheme, deregulation of tuition fees, bulk-funding of schools, Targeted Funding for Educational Achievement, the Targeted Individual Entitlement scheme and self-management in state schools, to name only a few.

At the end of November 1999, the progressive policy reform process was stopped. By the end of December 1999, it was in full retreat. The period since then has seen considerable policy backsliding:

- bulk-funding was eliminated;
- the *Legislation for Learning* regulatory review was canned;
- the TIE scheme was chopped;
- zoning was reintroduced;
- private school funding was capped;
- controls on tertiary tuition fees were reintroduced via the fee freeze;
- more and more taxpayer funding was being channelled to the tertiary sector through increases in Equivalent Full Time Student grants; and
- the terms of the student loan scheme were significantly softened.

In one sense, we should not make too big a deal of some of the changes at the school level. While some very good policies have been reversed, many others remain – the *Tomorrow's Schools* governance model has been retained and schools continue to have a significant amount of freedom to make decisions. The government has also made some improvements to the policy framework, including allowing alternative governance structures for schools, continuing the move toward full service education and closing a number of schools. But, on balance, the changes have been for the worse, in my view. And they have changed the nature of the community/school relationship with the centre. As one principal put it to me a few weeks back – "we used to go to the Ministry of Education for support, now we go for permission".

While the change process is not yet complete at the tertiary level, the outlook is grim. Indeed, the current minister's policy agenda invites comparisons to Jurassic Park. Like developer John Hammond in the movie Jurassic Park, the minister's policy initiatives have involved the resurrection of a number of long-dead policy dinosaurs, including the reintroduction of controls on tuition fees and a return to a command and control model for regulating the tertiary education sector. The policy agenda has more to do with palaeontology than policy and represents a "great leap backward" (with apologies to the McGillicuddy Serious Party), not a bold push into the knowledge nation. The student loan changes and increased subsidies are expensive, untargeted and amount to nothing more than middle-class welfare.

A key theme underlying the government's education reforms to date has been a reduction in the extent to which market mechanisms are used to allocate resources in the education sector. Choice and competition have given way to bureaucratic decree across a range of key decision areas. Auntie knows best. For example:

- the zoning changes will means less choice for students, particularly those in areas with under-performing schools;
- the fee freeze will limit institutions' ability to determine the right price/quality mix for their institution and will limit their ability to attract qualified staff;
- the elimination of bulk-funding will limit schools' ability to organise themselves in a way that meets the needs of all students;

- the Tertiary Education Advisory Commission (TEAC) could, depending on how it is implemented, limit institutions' course and programme mix, thereby limiting students' choices; and
- the abolition of TIE and the cap on private school subsidies will limit parental choice, again with those from lower socio-economic backgrounds are the most affected.

It is important to point out that the policy 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. As I will argue below, even the Smithfield Project research findings – so often heralded as 'the truth' by opponents of choice and competition – actually support the pre-1999 reform agenda. More importantly, the reforms of the 1990s seemed to be working well on the ground. Recent policy changes, by and large, have been driven by an unholy alliance of vested interests – labour unions, student unions and some well-organised provider groups.

Choice and competition in the education sector

Choice and competition are opposite sides of the same coin and I will use them interchangeably. Choice refers to what economists call the 'demand' or consumer side of the education market. Competition refers to the other side of the market, namely the provision or 'supply' side. The two concepts go hand-in-hand. Indeed, the notion of choice without competition is meaningless and is akin to Henry Ford's quote that "you can have any colour as long as it is black". Under a so-called market-based model that incorporates choice and competition, decisions are made, by and large, by consumers (parents, students) and by producers (early childhood providers, schools and tertiary institutions).

Competitive markets are a reality across a wide range of sectors of the economy – including education. Competition is generally seen to be a good thing. There is not much magic to it. Competition offers consumers convenience and choice, and ensures that providers have strong incentives to innovate, to be responsive to customer demands, to provide the levels of quality desired by consumers and to deliver services in an efficient manner. But why let consumers and producers make decisions? The answer to that is that parents, students and institutions are generally much better placed than central planners to make decisions about what type of education ought to be offered and how it should be delivered. Consumers and institutions also have much better information and incentives to respond to changes in the demand for skills. The National Competition Council in Australia put it this way:

> Competition contributes to achieving higher growth by helping to ensure that the community's resources – the physical environment, financial resources and people's skills and ideas – are used in the most valuable way. Accordingly, Australia's governments have taken the logical view that the disciplines imposed by effective competition, being the greatest drivers for improving productivity and encouraging innovation, need to be extended throughout all sectors of the economy …

While many in the education sector – including the authors of the Smithfield reports and the TEAC report – vilify competition, they provide few persuasive arguments to back up their claims. One key weakness in the argument of those who oppose competition is that they confuse the notion of scarcity with the mechanism for allocating these scarce resources. They are distinct and need to be separated. We live in a world of scarce resources and hence there is competition for those resources. You can't always get what you want – to quote Mick Jagger and Keith Richards. Because we live in a world of scarcity, we need a way of channelling those scarce resources to those uses that will contribute most to the betterment of society.

There are only two ways that can be done:

- a decentralised market model, incorporating choice and competition, that allows consumers and producers to make decisions about what should be produced, where and how; or
- a central planning model under which resource allocation decisions are made by a central authority.

The key message from the above is that the 'market' is not some sinister creation, it is simply a mechanism for allocating resources. Most of the debates over issues such as vouchers and school choice are therefore not debates about competition at all. As long as there is scarcity, there will be competition for resources. The only issues for debate are what form that competition will take and which method of allocating scarce resources is better – a central planner, or consumers and producers operating at the coal face. As one economic observer has commented:

> In its most fundamental sense, competition is ubiquitous to all economic systems. All forms of striving to enhance one's situation are competition. Indeed, there is competition wherever there is self-interest and scarcity. In this broad sense, neither government nor business policies affect the presence of competition, for neither self-interest nor scarcity is eliminated. The forms that competition take are, however, innumerable. The laws and rules of business conduct cannot increase or decrease competition, but they can and do alter the forms in which competition occurs.

It has often been argued that one of the goals of the TEAC reforms has been to reduce the degree of competition in the sector. Unless these reforms can deliver up a world without scarcity, that won't happen. All the TEAC reforms will do is change the way resources are allocated. And likely for the worse, in my view.

Despite its damning comments about competition, the second TEAC report provided no evidence or arguments to support its views. Nor could it explain why competition works well in virtually all facets of the economy, but not in education. The government's negative view of competition in education is consistent with its view of competition in areas such as accident insurance, labour markets and tariff reform. While the government has promoted its telecommunications and Commerce Act reforms as being pro-competition, the outcomes on consumers and the industry are likely to be adverse given the changes introduced. Once again, however, no reasons are given why the effects of competition will be bad in education but good elsewhere.

The negative view of competition in education is held 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 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 …

In commenting on the United Kingdom's experience under the Blair government, Howard Glennerster of the London School of Economics has noted that, despite stagnating education spending, education outputs (that is, outcomes) grew in a way "unseen in thirty years". According to Glennerster:

> The reason seems to be that a degree of competition, devolved budgetary responsibility, the setting of national standards and required following of good practice produced results … Head teachers now seem to strongly appreciate the degree of managerial freedom the devolved budgets have brought. The numeracy and literacy hours seem powerful ingredients. In short, it is doubtful if any one of these measures on their own would have produced the change. It would certainly be premature and retrograde to go back on any of them now.

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 peoples. This has included the development of Kura Kaupapa Maori, new forms of education such as Alternative Education and the development of Special Character schools.

A more market-based system would have another advantage in that it would ensure that where mistakes are made, they do not adversely affect the whole education sector. Decentralised systems have a built-in correction mechanism. Centralised systems do not. When you screw up, you screw up big time and there are strong pressures to maintain the status quo, even in the face of failure.

Choice and competition: international trends

School choice and competition are moving ahead at a great pace in other countries and New Zealand is being left behind, despite having been a world leader for many years. Let's look at some examples.

United States

In the United States, the school choice movement continues to gather pace, despite the voucher setbacks in last year's election ballot initiatives. And this movement comes in many forms. Vouchers are only the tip of the iceberg and are nowhere near the most significant aspect of the school choice movement, even though they do attract the most attention. For example:

- private management of public schools, whereby school districts contract out the management of individual schools to private companies, is expanding rapidly. Edison Schools, one of the leading school management firms, now has 136 schools in 45 cities with 75,000 students;
- private management of public school districts, whereby the management of the entire school district is contracted out to private companies, is more recent. But it too is growing. Tom Ridge, the governor of Pennsylvania has engaged Edison Schools to develop a plan to rescue the City of Philadelphia's woeful public schools. Among the options that is being considered is the take-over of all or part of the Philadelphia school district – all 210,000 students;
- Indiana is set to become the thirty-eighth state with legislation allowing the creation of Charter Schools. There are now more than 2,000 charter schools in the United States serving over 500,000 students;
- the private for-profit higher education sector is expanding rapidly in the United States. Institutions such as the University of Phoenix (with enrolments of nearly 100,000) and De Vry are having a marked impact on the shape of the higher education landscape;
- in August 1999, there were 57,000 students benefiting from 79 privately financed scholarship schemes in the United States. Over one million more students were on waiting lists;
- there is increasing use of tax credits as a means of financing private education, with Florida being one of the most recent to move in that direction;
- Standard and Poor's – the corporate rating agency – has begun providing school evaluation services. Michigan was the first state to contract with Standard and Poor's to deliver school evaluation services;
- Edison Colleges, which is part of the private for-profit Edison Project, is planning to start up its own colleges to train teachers. Plans are to train and develop some 50,000 teachers between 2004 and 2008. Edison will focus on 'hard to staff' areas such as math and science;
- a number of companies such as Kaplan Inc and TestU are part of an expanding private market in preparing students for various state tests; and
- the Florida legislature has vastly expanded the educational opportunities for students with disabilities. Florida's 340,000 students who have Individual Education Plans will be able to obtain a voucher to attend any public, private or parochial school.

This frenzy of activity looks set to continue. The Supreme Court in the United States is expected to hear a landmark case on the constitutionality of school vouchers sometime in the next year. This will be critical to determining the speed with which vouchers spread in the United States. The Bush administration's strong support for charter schools suggests that this too will be an area of considerable growth.

United Kingdom

The Labour government under Tony Blair in the United Kingdom has provided a model for public/private partnerships in education. Since its election in 1997, the government has:

- introduced the concept of Education Action Zones in areas where there was system-wide school failure;
- contracted out a number of Local Education Authority (LEA) functions to private firms;
- introduced the Private Finance Initiative, which is providing access to private capital to help upgrade education sector infrastructure; and
- introduced tuition fees at the tertiary level, along with a student loan scheme.

Many of the Blair reforms built on the Thatcher reforms of the 1980s and early 1990s, which included increased parental choice backed up by per-pupil based funding, national testing and the publication of results. In response to these initiatives, leading independent schools in the United Kingdom were considering forming companies to run state schools or take over LEA services.

Since its re-election, the Blair government has restated its commitment to using public/private partnerships to improve education where it is not up to standard. The government's White Paper on education, which was released a couple of weeks back, confirmed this policy direction – despite the protestations of those beholden to vested interests.

Canada

The choice policy agenda, though not as active as in the United States or the United Kingdom, is moving ahead. The Conservative government of Ontario premier Mike Harris continues to lead the way in education policy at the school level:

- in April 2001, they foreshadowed the removal of the province's strict school zoning laws; and
- in May 2001, they announced a tax credit (rising to Cdn$3,500 over a period of years) for parents with children in private schools, including parochial schools. That tax credit took effect this month as Ontario schools reopened.

And Ontario is not alone. Six provinces provide funding to private schools, including the Province of Quebec. The Province of Alberta has had charter schools for more than five years. In addition, public schools in Alberta's capital city Edmonton offer a range of curricula and qualifications, including the International Baccalaureate. And, unlike some in New Zealand, Canadian universities see no reason to allow ideology or political games to stand in the way of recognising these alternative qualifications.

There have also been a number of developments at the tertiary education level in Canada. These include:

- The Mike Harris government in Ontario announced last year that private universities would be allowed to operate in the province. That legislation is now in place.
- Tuition fees at universities and colleges have increased significantly in a number of provinces, including Nova Scotia, Ontario and Alberta. Students

entering arts and social sciences programmes at the University of Ottawa will pay annual fees equivalent to NZ$6,400 this year. Students in medicine will pay the equivalent of nearly NZ$17,000.

- Despite increases in government grants in recent years in some provinces, government funding fell to 55 percent of total university revenues – down from 69 percent a decade earlier.
- The Province of Ontario has completely deregulated fees for professional and graduate programmes and there are now significant differences in fees by programme type.

Other countries

Reform is not limited to these three countries. School choice and voucher systems operate in a large number of developed and developing countries – including Denmark, Sweden, the Netherlands, Ireland, Côte d'Ivoire and the Philippines. In Australia:

- the Victorian Labor Party commissioned ministerial review of public education recommended reforms based on "self managing schools … within a flexible and responsive public school system"; and
- the New South Wales government is reportedly looking at options for getting greater private participation in the financing and construction of public schools.

Many countries are making use of innovations in the area of quality assurance. These include private provision of school review and evaluation services, the provision of information for consumers and the use of private accreditation systems. In many cases, these functions are undertaken by education sector organisations, rather than by central government. The private sector in many countries plays a substantial role in regulation and quality assurance in the education sector. In many countries, this role is set down in law.

Concerns with increasing role for choice and competition

Let me discuss three possible criticisms that might be directed at increasing the role of choice and competition in the education sector and at some of the reforms outlined above.

These reforms would be resisted by education professionals …

First, won't teachers oppose such reforms? There is no reason why this should be the case. By the time bulk-funding was 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 rigid and unrewarding pay scales and bureaucratic paperwork.

Evidence from the United States suggests that school choice and competition would be good for the teaching profession:

- Caroline Hoxby of Harvard University presents evidence suggesting that school choice would change the teaching profession by demanding teachers with higher quality college education, more math and science skills, and more effort and independence;
- Richard Vedder and Joshua Hall of Ohio University found that, when viable private school alternatives exist, competition between public and private schools increases the salaries of public school teachers by as much as 5 percent;
- Dale Ballou of the University of Massachusetts Amherst and Michael Podgursky of the University of Missouri–Columbia found that, in making hiring decisions, private schools valued high aptitude more than public schools do and that salaries in private schools correspond to aptitude and scarce skills more than they do in public schools; and
- in a recent *Education Week* article, Tim DeRoche argued that competition would be "overwhelmingly positive for the average teacher. If schools must convince parents to enroll their children, then good teachers will be in great demand".

Teachers are beginning to come together in support of good policy, thereby bypassing unions who claim to speak on their behalf. One such group in the United States is Teachers for Better Education, a national organisation formed to discuss and promote education reform in the public school system, including the use of charter schools, education tax credits, opportunity scholarships and public school vouchers.

In 1999, the Alexis de Tocqueville Institution (AdTI) surveyed 50 teachers' associations in 12 countries and found that educators who have actually worked in a voucher system support school choice. According to the AdTI study:

- less than a quarter of teachers' associations opposed market-based reforms such as vouchers;
- in countries with significant experience with choice-based systems, more than half the unions backed voucher programmes and only 7 percent were hostile to them;
- union officials in Sweden, Belgium, Germany, France, the Netherlands, Australia and Denmark claimed that school choice 'works', even when it includes government support for private schools; and
- the gap between teacher pay in the public and private sectors is much lower in choice countries than in non-choice countries.

A key concern for the teaching profession in the United States and elsewhere is the shortage of teachers. One of the main reasons underlying these shortages is the absence of market signals and market disciplines in the education sector. Moving toward a more market-based system would help address this. Carlos Ponce, the chief human resource officer for Chicago Public Schools (which is facing severe teacher shortages), described it this way:

> The teacher shortage won't go away because government, which is the primary employer, is the slowest to respond to market forces.

Choice and competition would benefit the well off …

Wouldn't more choice and more competition simply benefit the well off? In my view, this is one the great myths of our time. Those who are well off already have choice in education – whether private schools or high performing public schools. By and large, it is the poor and disadvantaged who are locked out of the good schools – especially now that zoning is back. Choice and competition can benefit these groups – if it is done right. While this is a very complex matter, the evidence is mounting that choice and competition benefit the poor and disadvantaged. In New Zealand, the Smithfield Project's research showed that:

- students from Maori and Pacific families were the ones who took greatest advantage of choice when it was introduced in the early 1990s; and
- income segregation in schools fell after zoning was removed.

Schools with large numbers of students from disadvantaged backgrounds can only lose under a centralised system where the schools have little flexibility to do things differently and few ways of competing for good teachers. And this is not only true in New Zealand. Choice and competition are playing an increasing role in helping achieve greater equity and better education outcomes in the United States:

- companies such as Edison Schools operate primarily in low-income neighbourhoods;
- a recent study found that Catholic schools had favourable impacts on equity and that "increasing access to these schools through vouchers should result in higher levels of achievement for students who might otherwise attend lower quality public schools";
- a recent study by the Indiana Center for Evaluation at Indiana University found that students in the Cleveland Ohio voucher programme were achieving at significantly higher levels than their peers, and that competition was leading to performance improvements among students in public schools as well; and
- a large proportion of charter schools – which are less encumbered by regulations than regular public schools – have significant proportions of minority students.

The same is true at the tertiary level, where enrolments among traditionally disadvantaged groups such as Maori and Pacific peoples have increased rapidly since the market-based reforms of the early 1990s. Indeed, the private tertiary education sector in New Zealand plays a significant role in meeting the needs of at-risk/second-chance students, through programmes such as the Training Opportunities Programme and Alternative Education.

The powerful role that choice and competition can play in helping disadvantaged communities is increasingly being recognised by these groups. In the United States, the Black Alliance for Educational Options, a non-partisan coalition of educators, legislators, parents, clergy, and community activists, was established in August 2000. Its aim is to lift the persistently low achievement levels of African-American children by expanding the range of educational options available to African-American families – including vouchers, charter schools and private scholarships.

We need cooperation, not competition …

Another concern often raised with market-based policies is that they encourage competition, rather than cooperation. This has been one of the mantras of recent policy at both the school and tertiary education levels and has been used to support the return of zoning and the imposition of central planning at the tertiary education level. There are many problems with the argument though. First, it is premised on the belief that competition is bad per se. As discussed above, that is not the case.

Second, the issue of competition versus cooperation is presented too often as a false dichotomy – that we can have either one or the other, but not both. While that may be a convenient simplification for those unwilling to apply some thought to the issue, it is simply not true. Under a market-based system, we will have both cooperation and competition. Competitive firms cooperate at all levels of the production chain to deliver higher valued final products – whether electronics, cheese or newspapers. Few firms produce everything in-house. The same is true within firms, where many departments and employees must cooperate to generate the final product. Furthermore, the cooperation that occurs in a competitive environment will generally be of higher quality than in a non-market environment because organisations are brought together willingly and for value-adding reasons, rather than by central decree.

Finally, the imposition of cooperation does not eliminate the competition for scarce resources. As discussed above, there will still be competition. This will clearly be the case under the TEAC proposals, where the allocation decisions risk becoming much more political. So, rather than competing by trying to deliver what students want, tertiary institutions may well find they are putting more time and effort into competitive behaviour such as lobbying. The recent 'transfer' of $35 million in funding from private tertiary institutions to state tertiary institutions provides a good case in point. It is much easier to effect such a transfer through lobbying under a politicised 'cooperative' system than it would have been under a competitive market-driven system. Indeed, transferring such a large amount of money between the two sectors would have required state institutions to convince at least 7,000 students to shift from the private to the public sector. That would have used up a lot more shoe-leather than a few trips to the Beehive.

General comments

It is useful to raise a few general points regarding education policy.

First, education has a big role to play in fostering economic growth, but we have to be realistic about its potential. It is not 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. Ireland was producing large numbers of skilled graduates long before it became the Celtic Tiger. As one commentator said recently "education spending can't explain economic miracles".

Second, it is important to remember that the link between education and economic growth is a two-way street. We need strong economic growth and a rising standard of living if we are to finance adequately early childhood programmes, schools and tertiary institutions. The wider policy environment is critical for sustained economic growth. We need to provide stable macroeconomic policies, strong intellectual property rights, an open and skills-focused immigration policy and outwardly oriented trade and investment policies. 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.

Comparisons are often made to the high per-student funding levels in other countries such as the United States. We can never expect to match those per-capita spending levels while our income per capita is less than half that in the United States. They spend more on education in part because they can afford to. Recent New Zealand governments have not been frugal when it comes to education. A report from the Organisation for Economic Cooperation and Development (OECD) showed that:

- New Zealand's public expenditure on education relative to gross domestic product (GDP) was above the OECD average and fifth highest among 28 countries;
- between 1995 and 1998 expenditure on educational institutions as a percentage of GDP rose from 4.9 percent to 6.1 percent; and
- overall education spending 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.

The key message is you can't live a US lifestyle on a New Zealand salary. Ask anyone who has been to Disneyland on a 40 cent dollar. We need to adopt pro-growth policies to increase the size of the economic pie before we start to divvy it up amongst ourselves.

Third, I am not arguing that if we simply introduced greater choice and competition in education, everything would be okay. That is not what I am saying at all. There are no silver bullets in education policy. This is true of choice and competition. It is also true of increased spending. We need comprehensive reform to really make a difference. Many of the policies that I discussed earlier could be examined as potential ways of moving forward.

Fourth, I am not saying that there is no role for government in education. I am saying the exact opposite. There is a positive role for government. And that role has to be driven off a first-principles analysis, not special interest politics. We need to be clear about policy objectives, identify why the government needs to be involved and determine the best way that it can help. Markets may not always work for various reasons – externalities, capital market failures, equity reasons, and so on. But there are many ways that government can overcome these market failures – funding, loans or loan guarantees and information provision. Public ownership of institutions is rarely justified.

I see a need for a much more accommodating and flexible approach to regulating the education sector. This would reflect the diverse needs of the sector and the uncertainty in our knowledge about what works for particular students – who come from varying backgrounds and with different learning styles. A rigid, one-size-fits-all model does not work. This does not mean a wholesale withdrawal of government or wholesale decentralisation without thought. What it means is that we need to come to robust and clear-headed decisions about what the government should do and what education institutions and their customers (students, parents) should do. Governments should reinforce the operation of the market, not supplant it.

The role of government should move toward one of facilitator, rather than necessarily provider or decision maker. Too often we steer ourselves toward the seemingly 'obvious' solutions – more prescriptive government regulation, government ownership and government financing. The message from countries such as the United Kingdom, Canada, Ireland and the United States is that there are more effective ways of moving forward.

Fifth, more money is not the only answer. Yes, the education sector needs more resourcing and teachers are, in the words of Don Brash, "scandalously underpaid". A recent advertisement for an associate professor in finance at Victoria University was offering less than most senior analysts in government departments would make, yet they are competing for talent with public and private sector organisations paying considerably more than that. On its own, more spending will not necessarily deliver better educational achievement. There is a growing literature that shows this. For example, 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.

Clearly, there is more to creating a successful education system than more money. Money matters, but not only money matters. There is no better illustration of this than the experience of Kansas City, which undertook a 'cost-is-no-object' educational reform, yet saw virtually no improvement in terms of test scores, closing of the black–white performance gap or integration. As one observer noted, the Kansas City experiment suggests that "educational problems can't be solved by throwing money at them".

Finally, I am not arguing that this system will be perfect. No system ever will be – not with nearly 1,000,000 students, 2,700+ schools, 30+ tertiary institutions and 800 or so private training establishments. But then that is not the appropriate test. The appropriate test is whether this system is better than all the others. That is really all we can ask for.

Selling the message

You must think I am crazy telling you all this stuff. Isn't this the same old right-wing Rogernomics agenda that would be a recipe for political suicide? Hasn't the world moved on? While I may be crazy, the ideas I have raised tonight are not. Furthermore, they have nothing to do with Rogernomics or right-wing ideology. Indeed, these reforms are being introduced by governments of widely divergent political stripes – Labor and Conservative, left wing and right wing. The pro-choice movement is non-partisan. These reforms are simply a pragmatic and practical response to identified policy problems. Look at the evidence:

- the New Democrats, who represent the Clinton wing of the Democratic Party in the United States, are strong supporters of charter schools, charter districts and increased accountability;
- Andrew Rotherham, director of education policy at the Progressive Policy Institute, a Democratic think-tank in the United States recently came out strongly in support of standardised testing, arguing that "poor and minority students are the ones to suffer from the lack of common, verifiable standards";
- last year, Robert Reich, a former Labor secretary in the Clinton Cabinet – described by the New York Times as a "Democratic policy guru and friend of organized labor", proposed a progressive voucher scheme pegged to family income. Mr Reich visited New Zealand as a guest of the Labour Party in 1998;
- as discussed, the Labour government in the United Kingdom has provided a model for public/private sector partnerships. There are many examples of

forward-looking policies coming out of the United Kingdom, including Education Action Zones, contract management of failing public schools, the Private Finance Initiative and the star rating system for nurseries;

- Wendy Piatt of the Labour Party affiliated Institute for Public Policy Research in the United Kingdom called for greater differentiation in tuition fees at the tertiary level in the United Kingdom; and
- two weeks ago, Howard Glennerster of the London School of Economics, which is headed by 'third-way' proponent Anthony Giddens, praised the Blair government's efforts at addressing failing schools and argued that it had "retained and if anything strengthened" the education reform package that Margaret Thatcher had put in place.

Second, I don't come at this stuff cold or from the rarefied air of academia. I have worked most of my career as an advisor to various governments in Canada and New Zealand. I have seen the impossible become the possible. A good example of this was the move to align public and private funding in the tertiary education sector, where it took several years for our efforts in the Treasury to move that issue to the top of the policy agenda.

Despite this, selling a reform package will not be easy. The policy context is different in many ways and certainly less hospitable to sensible policy development, for a number of reasons:

- The basis of policy development has changed from policy to politics – those who are connected and who scream loudest do well. Others lose out.
- There is little serious discussion of policy issues in much of the press and there seems to be little questioning of anything in ministerial press releases.
- Policy discussions too often get side-tracked onto issues of process, rather than substance. Discussion of the merits or otherwise of the Kiwibank was almost lost in the sensationalist discussion of who was leaking what. After a few weeks, the Kiwibank almost seemed like a good idea – just to get it off Morning Report.
- The forces of light are small and under-resourced. You have no self-financed union movement ready to use its members' dues for political ends.
- Government departments are constrained in their ability to offer 'outside the box' advice.

But we should not be too pessimistic. There are several reasons for this:

- The longer-term forces driving change won't go away. The same global pressures that faced New Zealand the day before the last election face New Zealand today – indeed, they are probably heightened. In the long run, globalisation and the changing New Zealand economic and social landscape will drive policy change.
- Other governments – left and right – have managed to move sensible policy agendas forward. The governments of Tony Blair in the United Kingdom and Mike Harris in Ontario offer two good examples of this. I would also point out that Mike Harris moved from the political wilderness to being Premier of Ontario in a matter of weeks or months, thanks to his Commonsense Revolution.

- The forces of light are showing some signs of becoming more active in defence of the realm – despite the clear risks of adopting such a strategy.

Other countries have shown there can be considerable support for choice initiatives, as evidenced by the existence of significant choice programmes in countries such as Denmark, Sweden and Ireland. A COMPAS poll published in the *National Post*, a Canadian newspaper, in September 2001 showed that 57 percent of the Canadian public supported the introduction of school vouchers. This moved the newspaper to argue that:

> There is no longer any legitimate cover, let along justification, for politicians who want to prevent the introduction of vouchers. It is good policy and, given the survey results, also obviously good politics.

In my view, there is clear discontent with a number of aspects of education policy – whether around TEAC, the fee-freeze, zoning, bulk-funding or the National Certificate of Educational Achievement (NCEA). You need to harness these and give them an outlet. It will take more effort than has been exerted to date. Most of us have been disappointed at the performance of the opposition parties since the change in government. Disappointed first at their inability to mount much opposition to the reactionary policy juggernaut in the area of student loans, bulk-funding, zoning, and so on. And second, we have been disappointed at their apparent failure to put in place a coherent process for developing an alternative and positive vision. But I am not going to dwell on that. It is time to look forward, not back.

Conclusion

I think it is clear that in the area of education policy, New Zealand is moving increasingly out of step with international best practice. This is consistent with the policy direction in a range of other areas, as is so well documented by Phil Barry's recent piece for the New Zealand Business Roundtable. Time will tell whether recent policy changes are a short-lived detour or a fundamental and lasting shift in direction. Neither outcome is predestined. It is up to you to outline a forward-looking and positive vision for educational progress in New Zealand. An agenda that addresses the real issues in the sector and offers up real solutions, not just window dressing. If policies are to be durable, they need a strong policy basis. Half-baked responses to the clamouring of special interest groups don't meet that test.

You will need to outline – at a time of your choosing – a positive and workable alternative to the current set of policies in education. Governments around the world have introduced a range of innovative policies in the education sector. These provide some basic concepts for developing a 'made in New Zealand' education policy platform structured around choice and competition. They are not just pie in the sky proposals. They are real world policies that are being implemented and extended as we speak.

Whatever policy platform you choose at the school level, it has to go well beyond simply the return of bulk funding, the elimination of zoning and the reinstatement of TIE. That is simply not enough. At the tertiary level, it will be important to ensure that policies are built for the long term. Undoing some of the post-December 1999 reforms would be a good start. But here again, much more needs to be done – nobody believed the policy settings were perfect prior to December 1999. The tertiary education policy platform needs to be built on real analysis, not slogans or pressure from vested interests. Real progress toward a knowledge nation can only be accomplished through the introduction of robust, well thought through policies. Good policy can be good politics.

And whatever policy package you adopt, it has to be presented as a coherent vision. That was a problem in the 1990s. If you look back, there was an underlying vision to the reforms of that period, as discussed at the outset. However, it never seemed to be presented as such and people just saw it as an endless series of unrelated policy initiatives. Putting together such an agenda won't be easy, and it won't be done tomorrow. But, if you are to make a difference to education policy discussions, the time to start is now.

SOCIAL POLICY

ACCIDENT COMPENSATION SYMPOSIUM

THE ACCIDENT COMPENSATION SCHEME: A CASE IN PUBLIC POLICY FAILURE

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THE ACCIDENT COMPENSATION SCHEME: A CASE STUDY IN PUBLIC POLICY FAILURE

Purpose

I have been asked to comment on how and when the notion of competing private insurers for accident compensation emerged in the New Zealand debate in the 1980s and 1990s.

I am an economist with a career in public policy and finance. I am not a historian. It is easier for me to explain the economics of the case for competing insurers than to suggest why the debate did not emerge until the 1980s and 1990s. Yet, the contribution of economic analysis to the public debate was sadly neglected until the New Zealand Business Roundtable was formed and started commissioning diverse economic experts to research the issue. It has stuck to this task over the years and is surely by now the most substantial contributor to informed public debate on the matter.

The economic analysis is of enduring relevance to the question as to what issues must be addressed if New Zealand is not to spend another 25 years tinkering futilely with a system that lacks a coherent basis and endlessly shifts priorities because there is no sound basis for trading them off. To that extent the paper is forward looking.

For the history, the paper relies heavily on source material, most particularly the detailed study published by Geoffrey Palmer (now Sir Geoffrey) in 1979.[1] It also uses the brief but more accessible New Zealand Employers Federation review in September 1995.[2]

From a public policy perspective the history is relevant to any study into the underlying causes of the numerous major policy failures in New Zealand during the last 50 years.[3] If New Zealanders want a prosperous future the first step is to stop repeating past mistakes.

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1 Geoffrey Palmer (1979), Compensation for Incapacity: A Study of Law and Social Change in New Zealand, Oxford University Press, Auckland.

2 New Zealand Employers Federation (1995), *A New Prescription for Accident Compensation*, Wellington, pp 1–69.

3 The imposition of import licensing as a 'temporary' measure in response to the 1938 foreign exchange crisis formed the basis of the protectionist strategies of the next 40 years, while more successful countries adopted outward-looking strategies. Agricultural subsidies saw meat rendered into tallow. Energy policy failures led to the 'Think Big' projects. Lack of fiscal and monetary discipline in the 1970s and early 1980s saw major increases in effective tax rates without explicit parliamentary approval through fiscal drag, and the deferred tax increases implicit in deficit spending. The same short-termism saw new welfare programmes of potentially crippling proportions, notably the domestic purposes benefit and the 1975 national superannuation scheme. These were introduced without due regard for their future implications for tax rates, adult welfare dependency or child poverty and deprivation. The short-termism also led to the debilitating price, wage and interest rate freeze of 1982–1984 and the debt spiral that caused the 1984 foreign exchange crisis. The unnerving rise in welfare dependency during the last 25 years also arguably owes much to product and labour market regulations that destroy jobs, relatively high benefit levels and – as the US success in reducing it is demonstrating – an undisciplined approach to eligibility conditions. The planned ratification of the Kyoto Protocol smacks of more short-termism and policy failure.

The ACC's version of why and when

There is a succinct history of New Zealand's current accident compensation scheme (ACS) on the Accident Compensation Corporation's (ACC's) website. It first mentions the notion of competing insurers in the context of the terms of reference given in December 1990 to the *Working Party on the Accident Compensation Corporation and Incapacity*. It is probably no coincidence that this working party was commissioned by a new incoming government and convened by an economist – Bernard Galvin, a former secretary to the Treasury.

Prior to this development, the policy focus had been on making the scheme more ambitious under the direction of Sir Geoffrey Palmer. Sir Geoffrey played a major part in the 1969 White Paper, and was deputy prime minister in the government that received the 1986 Officials Committee report and the 1987 and 1988 New Zealand Law Commission reports when the Rt Hon Sir Owen Woodhouse presided over the Commission. The 1988 report recommended *inter alia* that entitlements should be extended to illness as soon as possible.

The ACC's history states that the terms of reference for the Galvin report suggested that one way to reduce the cost of the scheme to society would be to provide greater freedom of choice between insurers and create competition between the public and private sectors. It attributed the pressure for change to 'demands' by the Employers Federation and the Business Roundtable that employers stop paying for employees' non-work accidents and that the overall cost of the scheme be reduced.

The consumer welfare rationale for competition

Any unbiased reading of the Business Roundtable's submissions during this period would establish that its concerns were far broader right from the start. Its first foray into this area was a submission prepared in July 1987 with the assistance of an academic economist from Monash University, Ian McEwin. This submission did not propose, let alone demand, either of the goals mentioned. Instead, it proposed a reduced role for government through user empowerment. The concluding recommendation in its executive summary was:

> By encouraging the competitive supply of innovative accident insurance, returning the accident insurance decision back to the consumer, and encouraging safety through the competitive insurance and liability system, overall community welfare would be improved.[4]

Its follow-up submission in December 1987 stressed the lack of a sound analytical framework for the Law Commission's findings and their lack of economic sophistication. Again, it emphasised the need for a principled re-evaluation of the whole approach:

> The appropriate starting point is a reevaluation, based on the best modern scholarship, of the proper government role (or community responsibility) in promoting more efficient insurance and safety arrangements to reduce accidents, foster rehabilitation and provide the desired level of income replacement. There is a wealth of literature and analysis available on this topic … which the Law Commission does not appear to have examined and utilised.

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4 *Review of Accident Compensation: A Submission to the Law Commission* (1987), New Zealand Business Roundtable, Wellington, July, p ii.

> Submissions to the Law Commission from organisations with strong professional economic expertise have laid out a basic framework and broad conclusions supporting those presented in the Business Roundtable's [July 1987] study. It is submitted that the Law Commission should be guided by this analysis, and apply its expertise to the development of legal and institutional arrangements that will support an approach to accident disability based on appropriate legal incentives to encourage safety, the competitive provision of private insurance, consumer choice as to disability insurance and a role for the state in ensuring minimum cover and the means to acquire it.[5]

Between 1988 and 1990 the Business Roundtable commissioned further reports and submissions from an impressive number of independent academic economists. In 1990 alone it commissioned independent reports from Patricia Danzon, Michael Porter, and my employer at the time, Jarden Morgan. All these reports stressed the importance of incentives and competition for community welfare.[6]

Where did these economic notions come from? A clearly articulated rationale for the desirability of competition has been with us for centuries. Adam Smith most famously explained the virtues of competition and free trade more than two centuries ago. If competition is a virtue its antithesis – monopoly – is harmful by association. Indeed, economic theory has provided the analytical basis for anti-monopoly policies in the United States and in the Commerce Act 1986 in New Zealand.[7]

Economists recognise that market forces will generally overcome a private monopoly in time through competition (and the elapse of patent rights). However, natural and statutory monopolies are special cases that cannot be overcome by competition, essentially by definition. The degree to which natural monopolies are a problem is a controversial issue, but it is not relevant here.

Economists last century widely thought that statutory monopoly would be benign because governments were benevolent. This theory of regulation is known as the *public interest theory* or *normative analysis as a positive theory.* It assumes that governments actually behave in the public interest – that is, as an impartial spectator would wish them to behave. However, this theory has lacked supporters for several decades. There are two reasons for this: (1) no-one has been able to provide an analysis that explains how the public could induce legislators and regulators to act in accordance with this theory and (2) a large amount of evidence refutes it.[8]

Everyday experiences with state monopolies illustrate the complexity of the political and bureaucratic environments in which they operate. The lack of competition exposes them to severe conflicts of interest. Often they empower those who control them at the expense of their customers and taxpayers. Politicians find they have far less power than many imagine. For example, state schools and hospitals, or a fire

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5 *Review of Accident Compensation: Supplementary Submission to the Law Commission* (1987), New Zealand Business Roundtable, December, p ii.

6 Palmer, *op cit*, p 200, acknowledges the failure of the Woodhouse report to engage in economic analysis.

7 For a brief history of economic regulation, see Viscusi, W Kip, Vernon, John M, and Harrington Jr, Joseph E (1995), *Economics of Regulation and Antitrust*, The MIT Press, Cambridge, Massachusetts, 2nd edition, pp 311–317.

8 Viscusi *et al*, *op cit*, p 326.

service, might be effectively controlled by unions and professional groups that may produce mediocrity rather than strive for performance. The great frustration that results for customers and the best professionals is easy to observe in our schools, universities and hospitals.

Most commonly, state monopolies cannot be managed purposefully and cannot be held to account. This is because they lack a single overriding objective. Consider, for example, a decision that would increase output but reduce quality. If the state-owned enterprise (SOE) has the goal of increasing output and quality (for a given cost) the decision is arbitrary. Purposeful management is impossible.

The statutory monopoly that is the Accident Compensation Corporation has a host of conflicting objectives. 'Key' objectives encompass safety, rehabilitation and insurance. In every direction there are trade-offs between quantity and quality, speed and care. The history of the ACC is in good part a story of changing, politically driven priorities. Politicians (and the ACC itself) lack the information and incentives necessary to determine the actual priorities of the public when it comes to trading-off choice, quality, quantity and cost. When consumers are disempowered, changes in priorities probably reflect changes in interest group pressures.

The SOE model attempted to rectify this problem in other cases by imposing a single, overriding objective – the profit motive. However, the incentives to monitor SOEs in the interests of taxpayers or consumers are limited and management is not constrained by an active takeover market.[9] In any case, the SOE model is unstable. Sooner or later politicians will (re)introduce conflicting multiple objectives for political purposes that may not be laudable.

The benefits of competition are difficult to secure when even one competitor is state owned. State ownership creates a conflict of interest for governments. Its very existence can inhibit competition and price discovery. State ownership presents other problems for governments. For example, they do not know the SOE's cost of capital or how to best mimic market disciplines for under-performing management teams. For many years there was a debate in the empirical literature as to how much state ownership mattered for economic efficiency. This is more an issue of the vitality of the competitive process than the survival of the privatised firm. Privatisation is usually associated with deregulation in order to secure the gains from competition. To survive, the privatised firm will usually have to improve its performance markedly, but doing so will not guarantee its survival. As the recent near-demise of Air New Zealand demonstrated, this is not the way state-owned media, or many other journalists, will portray business failure. In the popular view, and alas in the view of some academic economists, business failure is a story of private sector failure and management incompetence rather than an inevitable product of the market's verdict on the relative merits of competing products or strategies.

Moreover, because competition is the key to consumer welfare, it is not clear that a heavily regulated privatised industry will perform much better than a state-owned industry. Much depends on the quality of regulation. Intensive regulation inevitably creates artificial distinctions between the regulated firms and the rest. These become entry barriers that impede competition.

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9 See *Economic Management* (1984), New Zealand Treasury, Wellington, p 293.

The benefits of competition are often not readily measurable. It is a common (self-serving) fallacy amongst antitrust regulators to point to lower prices as a benefit of 'introduced' competition. However, lower prices are not inherently desirable. Lower prices may herald lower quality and future supply problems, as in the Californian electricity crisis. One virtue of competition is that it should lead prices to *track* costs, where costs are subjective and forward-looking. Another virtue is that competition allows choice between quality and variety, and usually eliminates queues. Regulation (and monopoly) commonly takes on a 'one-size-fits-all' character. People resent its arbitrariness and lack of choice. Competition empowers the common consumer – and thereby civil society. This benefit is not readily measurable either, but that does not mean that 'reformers' should ignore it.

While economists have usually agreed about the benefits of competition, there has been more debate about the issue of government ownership. This was in part because of the problems of disentangling the issues of monopoly, ownership more generally, and regulation. However, by the early 1990s a strong consensus was developing that ownership matters for consumer welfare, with the World Bank to the fore in making the case in favour of private ownership.[10] That consensus has consolidated in the economic literature in the intervening years.[11] Moreover, it now accords with worldwide practice.

Why was competition from private insurers not an issue earlier?

Geoffrey Palmer has provided an interest group analysis of how the private insurers lost their battle in 1971–72 to preserve a role for themselves, notwithstanding the presence of a National government at the time.[12]

The impetus for the Woodhouse reforms came from a small group (notably lawyers), not public demand.[13] The reformers desired to replace a private insurance and liability regime by a social insurance regime – essentially for reasons of collectivist ideology and expediency. Socialism and confidence in the beneficence and competence of big government were at their height in the 1970s. The principles espoused in the Woodhouse report were based on collectivist values. In Geoffrey Palmer's sympathetic assessment they were:

> … a deliberate attempt to provide a reformulation of social aims on which a new sort of welfare state could be built.[14]

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10 For a review, see *The Public Benefit of Private Ownership – the Case for Privatisation (1992)*, New Zealand Business Roundtable, Wellington.

11 See, for example, William Megginson and Jeffrey Netter (2001), 'From State to Market: A Survey of Empirical Studies on Privatization', *Journal of Economic Literature*, June, pp 321–389.

12 Palmer, *op cit*, pp 115–123. He reports a senior government minister as commenting that the fire and accident companies failed to contribute to National Party funds and also suggests that they earlier adopted a too accommodating strategy.

13 Palmer, *op cit*, pp 66–67, 69 and pp 83–84.

14 Palmer, *op cit*, pp 56.

In so doing they "assume[d] the legitimacy of a large area for government action, the justification for which was never argued".[15]

Social insurance precludes the actuarially fair premiums that drive competitive (unregulated) insurance markets. Actuarially fair premiums provide individuals with an incentive to reduce their premiums by taking more care or providing more self-insurance. Healthier lifestyles and a better balancing of risk and reward should result. Flat premiums are a subsidy for risky activities and irresponsible behaviour. This can affront public opinion and undermine civil society.

These effects worry those who take incentives seriously. They may not worry those who take an optimistic view of human nature. Geoffrey Palmer no doubt rightly stressed the noble aspect of the collectivists' vision:

> The vision … was warm-hearted and humane. It took an optimistic view of human nature. The basic idea was that those in distress should be helped, that the well-being of each was a concern for all. Whether the vision and the efforts made to implement it represent significant social progress I leave it to others to observe.[16]

Nothing in this paper should be read as a challenge to the sincerity of the sentiments that underlay the 1967 Woodhouse report and its aftermath. However, public policies must be grounded in a sound appreciation of the flaws in human nature and the problems of information and incentives that commonly confound government action. Incentives do matter. One incentive is to exploit the power of the state. That power is readily abused and the natural tendency is for government to grow and liberty to retreat, as Thomas Jefferson famously observed. Another incentive is to take less care when the costs fall on others. Systems of social insurance are intended to delink costs and rewards.[17]

For example, a private accident insurance scheme would tend to insure only against accidents that have yet to occur or harms that have yet to be revealed. Those making false declarations concerning their pre-existing health status would not have a right to the premiums paid by others. In contrast, social insurance may pay out on harms that may not exist arising from long past events that may or may not have occurred – and if they did were deliberate crimes, not accidents.[18] But the most important benefit is that a private insurance system would not compel any person to contribute to a policy that was so open to abuse. Choice and variety would prevail.

The Woodhouse proposals were consistent with social insurance in that they proposed flat premiums that did not respond to risk differentials, but they were inconsistent in not proposing social insurance for loss of earnings from accidents *and* sickness. The inconsistency was presumably expedient – a halfway house was better than nothing.

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15 Palmer, *op cit*, p 205. Palmer also describes on p 93 how the 1969 Gair committee avoided the question of the relationship between ACC and the welfare system.

16 Palmer, *op cit*, p 407.

17 Richard Epstein sums up the differences between private and social insurance at pp 38–39 in *Accident Compensation: The Faulty Basis of No-fault and State Provision* (1996), New Zealand Business Roundtable, Wellington.

18 See, for example, the opinions reportedly expressed by Dr Felicity Goodyear-Smith in 'Sex abuse: 47,000 get compo of $100m', *The Dominion*, 14 March 2001.

In the event, the social insurance aspect was further undermined when the scheme that was implemented provided for industry risk rating in the assessment of premiums. The ACS is not the Woodhouse scheme, but Woodhouse is its father.

Sir Geoffrey Palmer acknowledged one of these inconsistencies in proposing legislation to extend coverage to sickness in the second half of the 1980s. However, this ambitious task was thwarted by the change of government following the 1990 general election.

Given the endless difficulties with the ACS, it was only a matter of time before the need was felt to clarify its conceptual basis. *Was it part of the welfare state or was it a system of insurance?* The debate on this issue in 1991 was the first to occur in front of those competent to assess economic arguments, and the Galvin report found in favour the insurance model and competitive private insurance. This recommendation was not picked up until 1998 when competition was introduced for the employers account.

The current government's decision to return to a state monopoly appears to have been entirely political and at odds with professional advice. It solves none of the problems that arise from statutory monopoly and persuades no new constituency of its merits. It can have no stability.

What about the future of the right to sue?

The Woodhouse report was also expedient in its drive to abolish the right to sue. Sir Geoffrey Palmer summed up the rationale for abolition as follows:

> Strategically it was essential to the Woodhouse style of reform that a compelling case be developed against the common law. If the common law survived, a comprehensive system for injury was unattainable. If the common law remained, the financial logic of the reform was destroyed – new sources of revenue would be needed rather than making better use of the existing money.[19]

The argument at the time was that the money spent on litigation could be better spent on helping the victim. Viewed from an insurance perspective, lawyers siphon off all too much of any award from a successful action under a tort system.

This political argument successfully confused an insurance system with a liability system. A tort liability system is concerned with determining cause or blame and penalising the same. Its economic value lies in the salutary signal it gives to onlookers and the incentives it thereby generates to avoid future accidents.[20] It also accords with a deep desire for justice – those who cause injury to others through irresponsible behaviour are held to account and confronted with the costs if found to be at fault. In contrast, an insurance system is concerned to provide relief to the victim regardless of fault. The two systems form an harmonious whole; they are complementary. Woodhouse's 'success' was to present them as substitutes.

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19 Palmer, *op cit*, p 25.

20 For a dialogue involving Richard Epstein and Geoffrey Palmer on the deterrence effects of tort processes in relation to empirical work by Michael Trebilcock and others, see Epstein, *op cit*, pp 20–21 and pp 39–41.

The rationale for denying common law remedies for personal injuries may have been more defensible if they were having irredeemably perverse effects. However, at least one of the scheme's proponents freely acknowledges that this was not the case:

> While the right to sue existed in New Zealand, it was not availed of nearly with the same vigour or with the same determination that it has been in the United States. Contingent fees, of course, were unlawful in New Zealand. There were a number of actors which tended to make this a moderate system. The judges controlled it. Even though the juries made the findings of liability and the awards of damages, the judges controlled it much more than is possible in the United States because they were allowed to comment on the evidence. When judges comment on the evidence in New Zealand, the juries tend to take notice of them.
>
> You cannot find, therefore, in the legal system of New Zealand or in the jurisprudence relating to the tort system anything that has any explanatory power in relation to the accident compensation scheme. There was little in the way of abuse or excess. It was a most mild-mannered little tort system.[21]

Unprincipled arguments produce stable policies only by chance. Although in 1979 the right to sue might have looked well dead and buried, subsequent developments point to a different conclusion. In recent years, judges appear to have restored a system of liability through judicial activism in the form of awarding exemplary damages in favour of the victims of accidents.[22] Furthermore, the abolition of lump-sum payments in 1992 and their replacement by an independence allowance appear to have reduced trade union support for retaining the abolition. It is also interesting to note that the greatest opposition to the original proposal to abolish the right to sue came from the insurers.[23] Presumably, the return to a system of competing insurers will add to this constituency.

The issue of the return to the right to sue was addressed in considerable detail by the author with the assistance of Richard Epstein and other lawyers in a chapter of a report by Credit Suisse First Boston for the Business Roundtable in November 1998.[24] The only factors that stopped a clean favourable recommendation were the concerns about judicial activism and the absence of guidelines for behaviour and cost awards, particularly during any transitional phase. The concerns focused on the need for sanctity of contract in relation to assignments of risk and the need to guard against capricious and excessive awards. These concerns are capable of being addressed.

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[21] Sir Geoffrey Palmer (1993), 'The New Zealand Experience', *University of Hawaii Law Review* 15(2), p 612.

[22] The paper to this conference by Ailsa Duffy, *The Common Law Response to the Accident Compensation Scheme*, outlines this evolving response and concludes that the pressures to revive the right to sue will grow.

[23] Palmer, *op cit*, p 67.

[24] New Zealand Business Roundtable (1998), *Accident Compensation: Options for Reform*, chapter 6.

Lessons for public policy

In its 1995 annual report the Law Commission identified six recurring sources of poor quality regulation. The following convenient summary is taken from a recent Business Roundtable publication:[25]

> First, *inadequate problem definition.* Framing the problem too narrowly or too broadly, or wrongly identifying it, results in policies and legislation which are inappropriate and ineffective.
>
> Secondly, *an assumption that legislation is needed when it may not be.* This may be the result of inadequate and delayed legal advice.
>
> Thirdly, a *failure of the legislation to give effect to the intended policy.* This is often a reflection of the first problem and the next.
>
> Fourthly, *premature introduction of legislation.* This is a growing problem in the Commission's view. It leaves large and complex issues to be grappled with by select committees. Resolving those issues takes time and resources which are more profitably used at the drafting and policy development stages. Under-prepared legislation also compromises the public submissions process, especially when the need for further development is acknowledged at the time of its introduction.
>
> Fifthly, *a failure to comply with accepted constitutional principle.* One example is the use of open-textured drafting. This could be a legitimate choice (for example, to leave the development of the law in certain areas to the courts), but there must as well be proper and comprehensive policy development before the legislation is introduced.
>
> Sixthly, *a failure to draft law which is as understandable and accessible as possible.* Improvements can be observed, but much legislation could be written more plainly, with major advantages to those affected by it.[26]

Inadequate problem definition

Geoffrey Palmer's study of the policy processes makes it clear that there was little public demand for change:

- "a balanced assessment" of the pressures for change "would not have concluded that much change was needed";[27]
- the assessment of the virtues and deficiency of the common law in the Woodhouse report was one-sided, neglecting, in particular, issues of justice, pain and suffering and intangible loss;[28] and
- in contrast, "everyone agreed" that the regulated benefits for workers' compensation, which had not been reviewed since 1956, needed to be "substantially upgraded and that the need to do so was urgent". Palmer expresses the view that it is possible that "anything resembling a full

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[25] New Zealand Business Roundtable (2001), *Constraining Government Regulation*, p 39.

[26] New Zealand Law Commission (1995), *Report 33: Annual Report 1995*, Wellington, pp 14–15.

[27] Palmer, *op cit*, p 69.

[28] Palmer, *op cit*, p 31.

> Woodhouse scheme" would not have come to pass if this upgrade had occurred.[29]

An assumption that legislation is needed when it may not be

It is clear that the contemplated legislation was not needed in order to address the problem that benefit levels were undesirably low because of the failure to review an existing regulatory imposition. The legislation was only necessary for the pursuit of an ideological goal.[30]

Premature introduction of legislation

Palmer comments that the original New Zealand Bill would not have passed the scrutiny of the Australian Senate Standing Committee for Legal and Constitutional Affairs. In his assessment the New Zealand Bill was primitive compared with the Australian Bill.

> The deliberate approach in New Zealand was to pass the Bill and start the scheme working. Amendments were to be made in the light of experience.[31]

A failure of the legislation to give effect to the intended policy

The actual legislation was a compromise between social insurance concepts and private insurance that (inevitably) lacked a coherent basis. FA Hayek has observed that the process of decision making by factions and majority rule can be expected to produce outcomes that a majority would oppose.

> What we call the will of the majority is thus really an artifact of the existing institutions, and particularly of the omnipotence of the sovereign legislature, which by the mechanics of the political process will be driven to do things that most of its members do not really want, simply because there are no formal limits to its powers.[32]

The payout of over $100 million to 47,000 people for sexual abuse claims, particularly in the absence of adequate validation in all too many cases, surely demonstrates such a situation.[33]

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29 Palmer, *op cit*, p 88.

30 Peter McKenzie's address to this conference: 'The Compensation Scheme No-One Asked for: The Origins of ACC in New Zealand', illustrates the point.

31 Palmer, *op cit*, p 203.

32 Hayek, FA (1991), 'Economic Freedom and Representative Government', in *Economic Freedom*, Masters in Modern Economics series, Institute of Economic Affairs, Basil Blackwell, Oxford, United Kingdom, pp 385–386.

33 *Constraining Government Regulation, op cit*, p 42.

A failure to comply with accepted constitutional principle

The overriding by statute of the common law is a serious matter in relation to constitutional government and the preservation of liberty and democracy. Respect for common law rights is a bulwark against despotic government.[34]

Palmer acknowledges the significance of the decision in New Zealand to end the right to sue in relation to personal injury from accidents. His study highlights how much weaker the constitutional constraints were in New Zealand at the time than in Australia:

- In New Zealand the collectivist vision of community responsibility in the Woodhouse report was "never attacked". Yet, if it was accepted, much had to be conceded. In Australia, the same idea was attacked in parliamentary debate as "the death of individualism".[35]
- In Australia, the prime minister had to obtain formal constitutional advice. The power of the federal government to bar proceedings for damages that were a right under state law was in question and only a decision by a High Court in Australia was authoritative.[36]
- In Australia, the constitutional argument in relation to the proposed blocking off of the common law ability to sue on behalf of injured children "was decisive".[37]
- In Australia, the opposition could thwart a determined prime minister because the government at the time did not have a majority in the Senate.[38]

Because this address is to a legal audience I will not bore it with more than a few brief remarks about how an institutional economist might evaluate the ACS. An economic analysis starts with exactly the same question as a legal analysis – what problems are people actually experiencing that the government intervention is intended to address? The analysis should move from symptoms to causes. If government action is still to be contemplated, its objective should be determined in the light of those causes. Proposed interventions should be evaluated against that objective. The evaluation would take into account such matters as the quality of the incentives the intervention would put in place and the degree to which it made it more or less costly for people to transact. For example, if the problem were that benefit levels were perceived to be too low, the problem definition phase might ask what was stopping those who wanted higher benefit levels from funding them.

It is almost inconceivable that any competent economic analysis could have identified actual harms to the common person with existing arrangements for which the solution was a state monopoly insurer and the abolition of the right to sue.

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34 *Constraining Government Regulation* cites Bruno Leoni as positing that legislation in matters of private law is fundamentally incompatible with political freedom and is not really compatible with free markets (see p 81). It proposes that regulatory proposals be explicitly tested for the degree to which they preserve venerable common law causes for action against harm (see p 212).

35 Palmer, *op cit*, p 205.

36 Palmer, *op cit*, pp 279–283.

37 Palmer, *op cit*, p 209.

38 Palmer, *op cit*, p 209.

In contrast to a practical approach to problem definition, the Woodhouse report conceived the problem to be that the world was not how the reformers would like to see it. They dreamed of a world in which everyone was collectively responsible for everyone's actions but their own. In their world, incentives did not matter because they had "an optimistic view of human nature". In contrast, the common law freedoms of choice and contract and the system of tort remedies that the government overturned so lightly was a product of over a thousand years of testing against actual human nature. Its evolutionary path is undoubtedly flawed but this is not a case for its displacement by flawed political decision making. We have yet to escape the folly of utopian thinking and the *hubris* of the anointed.[39]

Concluding remarks

Some might argue that the survival of the ACS for over a quarter of a century demonstrates that it is here to stay. However, much greater follies lasted longer – import licensing, communism, the Berlin Wall and apartheid. The longevity of the ACS is trivial in comparison with that of the common law regime it so cavalierly displaced.

There appears to be no principled defence of a state monopoly insurer. The benefits from the introduction of competition were dramatic and it is only a matter of time before ideology must bow to reason.[40] Nor is there any detectable stability in the debate going back to 1969 between the social insurance model and the private insurance model. The evolving rorts and inequities of the social insurance approach will continue to affront public opinion when they are drawn to its attention.

The stability of the abolition of the right to sue must also be in question. It is plausible that there is a deep need for justice to be done in cases of serious negligence – witness the public's response to the Erebus and Cave Creek disasters.

A greater constitutional respect for the preservation of common law rights in New Zealand might have prevented the unprincipled and opportunistic abolition of the right to sue that was critical to the success of the Woodhouse scheme. It is ironical that the charge to abolish it was led by (some) lawyers. Perhaps in 20 year's time the verdict will be that this was yet another folly associated with the New Zealand dream to 'lead the world' in social reform.

The advent of competing insurers and the restoration of the right to sue would not end the debate about the proper role of the state in relation to workers' compensation. The history of state intervention in workers' compensation is about a century old. It predates the enthusiasms that led to the Woodhouse proposals.

Prior to 1900, workers in New Zealand relied on the common law for compensatory redress. Legislative changes in Britain in 1897 and a major mining accident in New Zealand in 1896 led to the Workers' Compensation for Accidents Act 1900. After 1900, employers were liable for all work accidents except those caused by serious

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39 The reference is to Thomas Sowell (1995), *The Vision of the Anointed: Self-Congratulation as a Basis for Social Policy*, BasicBooks, New York.

40 I note David Caygill's paper to this conference that argues that the ACC's improved performance is not due to competition (or monopoly). Hopefully, it would have indeed improved its performance in the absence of competition. However, this barely touches on the issues of information and incentives, choice and variety that underlie the case for competition. The ACC cannot offer value for money because consumers cannot signal what they really value.

misconduct by the employee. This Act was rapidly replaced by the Workers' Compensation Act 1908. The 1908 Act increased substantially the maximum compensation payable and, though frequently amended, formed the basis of workers' compensation for the next 65 years. Under this Act employers were liable for all accidents, with a prescribed schedule for maximum payments and a proportional scale of compensation for incapacity. In 1947 it became compulsory for employers to insure against accident liability. At the same time a Workers' Compensation Board was set up to cover workers whose employers had failed to insure, recover those payments from the employer and set the maximum rates that state or private insurers could charge. Common law remedies for personal injury or property damage were also available for work and non-work accidents. Workers could take common law actions against negligent employers in order to augment their compensation, although damages awarded were likely to take into account the amounts already received.[41]

Notwithstanding the growth in collectivism during this period, an enduring theme is the humanitarian concern with the plight of law-abiding workers and their families when they suffer serious injury and are inadequately insured.

Even so, humanitarians must be concerned with the human plight rather than its cause – accident or sickness. In the absence of a monopoly accident insurer we would expect to see a much deeper market for income-replacement insurance and health insurance that covered both accidents and sickness. Then there would be the issue of the interface between this system and the welfare state and its relationship to private, voluntary, humanitarian activities and organisations in general.[42]

The focus on workers' compensation is much too narrow from a humanitarian perspective and the attack the ACC represents on common law rights smacks of an elitist disregard for constitutionalism. Until someone can produce a principled public policy defence for monopoly and the removal of common law rights, the ACC's tenure looks fragile.

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41 The historical information here is based on section 1 in *A New Prescription for Accident Compensation*, New Zealand Employers Federation, September 1995, pp 1–69. See also the boxed section on p 197 of the 2000 *New Zealand Official Yearbook*, Statistics New Zealand, Wellington.

42 For a discussion of the issue of the uninsured, see Epstein, *op cit* pp 33–35.

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NEW ZEALANDERS' SAVINGS HABITS: ARE THEY REALLY POOR?

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WELLINGTON
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NEW ZEALANDERS' SAVINGS HABITS: ARE THEY REALLY POOR?

Introduction

The American actor and writer Will Rogers once observed, "It's not what people don't know that's the problem, it's what they do know that's not true".

Because they have been told so often, New Zealanders 'know' that they are poor savers; that low saving means low economic growth; and that government action is needed to cure their bad habits. In particular, the government needs to 'do something' because New Zealanders are currently making inadequate provision for their retirement.

The purpose of this paper is to examine the validity of this familiar mantra.

Are savings low?

For decades there have been concerns that savings have been too low, and not just in New Zealand. The Labour government of the late 1950s wanted to increase savings. So too did the Planning Council in the 1970s. Sir Frank Holmes told the Economic Summit in 1984 that New Zealand had been relying too heavily on foreign investment and should increase its domestic savings. Reserve Bank of New Zealand governor Don Brash recently said New Zealand's savings record "looks particularly poor". Many commentators have made similar comments about the apparent decline in measured household savings in the United States and other countries in the 1990s.

These claims have persisted despite the fact that they have been contested many times. The McLeod Tax Review commented last year that:

> [W]hen looking at the impact of savings on the current and future well-being of New Zealanders, the most relevant measure is national savings; that is, the sum of private and government savings. On examining the available evidence and the reasons why people save, it was not clear to us that New Zealanders save too little.[1]

The Review added that a number of submissions disputed this conclusion but that "None, however, cited any supporting evidence other than a claimed consensus among relevant experts that there is a problem".

By far the most exhaustive recent attempt to assemble evidence on New Zealand's savings level and trends is a Treasury Working Paper by Iris Claus and Grant Scobie.[2] The paper highlights the problems with the measurement of saving and the difficulty of drawing clear implications for policy. It should be compulsory reading for anyone interested in the savings debate. Among the points it makes are that:

- Saving is difficult to measure (in New Zealand and elsewhere) because of factors such as hidden economy activities, depreciation (which is an unobserved variable), and the difficult distinction between households and businesses.

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1. McLeod Tax Review 2001, Final Report, October 2001, p 93.
2. Iris Claus and Grant Scobie (2002), 'Saving in New Zealand: Measurement and Trends', Treasury Working Paper, New Zealand Treasury, Wellington.

- In New Zealand, national saving is calculated from two sources of data: (i) from the national income and outlay account as the difference between disposable income and total consumption expenditure, and (ii) from the flows of investment and net lending in the capital finance account. Definitional changes can have large effects, as illustrated by the revisions to national saving from SNA68 to SNA93.
- Household saving is obtained from the income and outlay accounts only, and does not have the same degree of accuracy as the national saving rate.
- Saving as measured in the national accounts does not correspond very closely to theoretical concepts of saving. This measure also counts as current consumption many items such as education, some health expenditures and consumer durables which are arguably investment goods. Adjusting for such treatment substantially raises the national savings rate.
- The flow measure also ignores changes in household wealth such as homes and financial assets. The alternative stock measure of household wealth is more relevant for assessing the adequacy of retirement saving, but little information is available on the assets and liabilities of individual New Zealand households. The wealth survey being undertaken by the Office of the Retirement Commissioner will help fill this gap. (Estimates for the United States suggest that if realised and unrealised capital gains were included in saving, the savings rate would actually have increased during the 1990s.)
- Inflation also distorts the flow measure of private saving, because it transfers resources from lenders to borrowers.
- When adjustments for inflation are made, there has been no apparent downward trend in the level of private saving in New Zealand and, more importantly from an economic perspective, national savings rates could be much higher than suggested by the conventional measures.

A further point is that there is an inverse relationship between the household savings rate and the government savings rate (fiscal surpluses and deficits). Household savings rates fell in the early and mid-1990s as budget surpluses were achieved and rose in the late 1990s as the fiscal position deteriorated.

Having regard for other factors such as demographic trends that are relevant in making international comparisons, I am unaware of any convincing evidence that New Zealanders are poor savers.

This conforms with simple intuition. Saving is deferred consumption. We save in order to meet our expected consumption requirements in the future. Most people spend most of their income over their lifetimes. It would be surprising if the choices New Zealanders make between current and future consumption differ greatly from those of people in comparable countries. Certainly, the split between private and government savings could vary depending on the roles undertaken by governments in areas such as education, health, housing, welfare and retirement income. However, it is a plausible hypothesis that New Zealand's overall national savings rate, properly measured, would not differ greatly from those in countries with similar income levels.

Savings and economic growth

One of the main reasons why some people worry about saving is that they assume there is a close and causal relationship between national saving, investment and economic growth. Such beliefs are common among parties on the political left and central planners, but are not confined to them. The Soviet Union's economic policy was founded on 'primitive socialist accumulation', and 'capital fundamentalism' was an earlier feature of the development strategies of many developing countries. But, as the experience of such countries and the contrasting experiences in the 1990s of the United States (which has one of the lowest savings rates as conventionally measured) and Japan (with a high measured savings rate) shows, savings and economic growth are not necessarily closely related in economies with open and well-developed financial markets.

A successful effort to raise national savings and investment rates might have little effect on economic growth. A basic growth model suggests there would be a one-off increase in per capita income but no permanent effect on the rate of growth. More sophisticated models produce similar results. Consumption per head – which is what we are seeking to maximise – could actually fall because of the greater burden of capital depreciation.

Several other relevant points emerge from the economic literature about the relationship between savings, investment and growth:

- The magnitude of net saving in advanced economies is only a tiny fraction of the value of the existing capital stock. Policy initiatives that improve the use of the entire capital stock can have a much larger effect on national output.
- In open economies investment is not constrained by domestic savings. Financial sector liberalisation means that firms can access vast global capital markets – profitable investments are unlikely to go begging for lack of funds.
- The causal connection between savings and growth may not run in the direction that is commonly supposed. Some researchers have concluded that growth drives savings rather than the other way round, and that savings typically rise with per capita income.
- Modern accounts of growth, including the so-called 'new growth' theories, place primary emphasis on the importance of policies and institutions that are conducive to high levels of economic freedom as the key determinants of productivity and innovation.

A second recent Treasury paper confirms these general findings.[3] It notes that New Zealand's average investment rate at around 22 percent of gross domestic product (GDP) ranks in the middle of the Organisation for Economic Cooperation and Development (OECD) rates, and finds that "there is no obvious link between domestic saving, investment, the current account and real output growth". It also finds that the supply of venture capital does not appear to be a significantly constraining factor for New Zealand, thus implicitly questioning the government's recent incursion into this field. The authors conclude that "policies to promote domestic saving are unlikely to enhance economic growth. Such policies would need to be justified on other grounds".

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3 Iris Claus, David Haugh, Grant Scobie and Jonas Törnquist (2001), 'Saving and Growth in an Open Economy', Treasury Working Paper 01/32, New Zealand Treasury, Wellington.

Should governments seek to influence savings?

Savings are not an end in themselves – rather they are a means to future consumption opportunities. It is hard to see why governments should attempt to dictate the choices people make between present and future consumption. Consider two scenarios.

First, Michael Novak tells the story of two professional women who opt for very different lifestyles. One lives frugally but saves significant sums every year and ends up with a million dollars in mutual funds and a pension. The other enjoys the good life, food and travel, and ends her career with just enough to make ends meet in retirement. Do these sisters envy each other? On the contrary. They feel sorry for one another. Each thinks the other is crazy. Why should a government interfere with their choices?

Second, suppose that governments could somehow force people to save more and that higher savings led to higher growth. Would that be a good thing? Governments could also legislate for a 60-hour week, which would boost GDP, but most people would regard themselves as worse off. Income and wealth are at best very imperfect measures of welfare – forgone consumption and forgone leisure in the respective cases would offset the income gains for most people.

In fact, there is little evidence to suggest that governments can materially influence national savings levels other than through their own decisions on government savings (budget surpluses) or dissavings (deficits). Study after study has shown that compulsory savings schemes and tax incentives for savings alter and distort savings patterns but have little or no effect on aggregate savings. The McLeod Tax Review concluded:

> [E]ven if it were considered desirable for New Zealanders to save more, there is little evidence that changes to the tax system will induce higher saving, other than by redistributing income from those who are less likely to save (typically, poorer households) to those who are more likely to save (typically, wealthier households).[4]

This is consistent with OECD advice that "the theoretical and empirical evidence provides hardly any firm ground for relying on tax policy to affect private savings levels on a significant and permanent basis".[5]

Why then, despite the evidence, do governments have a perennial urge to interfere in savings decisions? One answer is that some politicians simply want to run other people's lives. Another is that they can buy votes by bribing taxpayers with their own money. Also, there is constant lobbying from vested interests for government intervention. To its credit, the Investment, Savings and Insurance Association stated in 1999:

> The ISI is not looking for favoured tax treatment for the products its member companies sell. New Zealand does not need more inequities in its tax system.[6]

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4 McLeod Tax Review, *op cit*, p 93.

5 *OECD Economic Surveys: New Zealand*, December 2000, p 127.

6 Investment, Savings and Insurance Association of New Zealand (1999), *Towards an Ideal Taxation Regime*, Wellington, p 2.

The government has also recently rejected a return to tax incentives, although it created one with its increase in the top personal tax rate to 39 percent by introducing a gap between the tax on fund earnings and the tax rate of many investors. However, vested interests have a habit of coming back, and the National Party has mooted the idea of reintroducing tax incentives. This should be opposed as having no basis in professional analysis.

Does all this mean that there is no reason for concern about savings patterns and levels in New Zealand? To the contrary. It is true that the environment for savings was improved with lower inflation, deregulation of the financial system, the introduction of a goods and services tax (GST) and an end to public sector dissavings. However, there have subsequently been backward moves, including higher levels of government spending and hence the overall tax burden, and a widening of the tax scale, which has accentuated distortions such as the treatment of housing and increased administration and compliance costs. In addition, the government's extensive role in health, education, housing, welfare and retirement incomes reduces the need for self-provision – why save if the government does the job for you?

It follows that the environment for saving could still be materially improved. The income tax at its present level discourages savings: the earlier strategy of reducing the government spending ratio in the economy and moving to a lower and flatter tax scale has not been carried through. The reintroduction of tax incentives as proposed by National would be a further retrograde step: at an annual cost of around $145–170 million, it would limit the scope for cutting the top rate by about 2 percentage points, or a third of the Labour–Alliance government's increase. Political parties that are serious about returning New Zealand to the top half of the OECD income ladder must simply commit themselves to lower levels of spending and taxation.

Given lower tax rates and higher disposable incomes, there is extensive scope for many middle and upper income earners to rely less on government-provided social services, which are often of inferior quality, and assume greater personal responsibility. Such changes would not necessarily increase aggregate national savings but, by conforming more closely with standard efficiency and equity criteria, they would lead to better economic and social performance.

Finally, on the specific issue of retirement incomes, the McLeod Tax Review noted that:

> … there is little evidence that most New Zealanders are currently making inadequate provision for their retirement. New Zealand's system of universal superannuation cannot be ignored in this context; it seems reasonable to conclude that virtually all current recipients of New Zealand Superannuation who have a mortgage-free home and relatively modest savings consider themselves to have at least a medium standard of living … We therefore take the view that, against the backdrop of universal provision of New Zealand Superannuation, most New Zealanders would not be well served by being induced or compelled to make additional retirement provision at the expense of living standards during their working lives.[7]

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[7] McLeod Tax Review, *op cit*, p 94.

The residual question, of course, is whether current government retirement policies are optimal. Regrettably, this is still not the case. Despite some moves to improve the environment for savings and modify the government scheme, there have been backward steps, such as the move to universality and the increase in the benefit rate. The new Superannuation Fund is another diversion that will do nothing to solve the long-term problem. The key point to keep in mind is that rather than having a narrow focus on savings, the focus of retirement income policies should be on economic growth. As one study put it:

> The key to providing high incomes in retirement is the pursuit of policies promoting high economic growth. Policies to this end are rarely focused just on retirement and superannuation issues but cover taxation, government spending, government regulations, labour market arrangements, and the incentive and reward structures facing individuals, private business enterprises and governments. With an expanding economy, most people should be able to self-provide for their retirement income, and should face incentives to save and to consume which are level and fair across their lifetime: the basic role of a government pension is to provide a bottom safety net against the problem of aged poverty.[8]

Federal Reserve chairman Alan Greenspan recently made a similar point about growth when he told a National Summit on Retirement Savings:

> Retirees may have accumulated a large stock of retirement savings, but the goods and services needed to redeem those savings must be produced by an active workforce assisted by a stock of plant and equipment sufficiently productive to meet the needs both of retirees and of a workforce expecting an ever-increasing standard of living.
>
> Though from the point of view of an individual household, saving reflects financial claims adequate to meet future needs, the focus for the economy as a whole, of necessity, must be on producing the real resources needed to redeem the financial assets.[9]

Conclusion

As I read the economics literature, saving is not a controversial issue – the general conclusions of this paper have been well established. Most of what we think we know just ain't so. In particular:

- The measurement issues with savings are well known, and there has long been scepticism that, given appropriate adjustments, savings rates across countries vary as widely as is often assumed.
- There is no convincing evidence that New Zealand's savings record is poor.
- Theory and evidence indicate that domestic saving and investment is but one source of economic growth, of less importance in advanced countries than

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8 Anstie, R, Freebairn, J and Porter, M (1989), 'Superannuation and government aged pension schemes for a dynamic economy', Centre of Policy Studies, Melbourne.

9 Alan Greenspan (2002), 'Saving for Retirement', National Summit on Retirement Savings, Department of Labor, Washington DC, 28 February.

productivity-enhancing factors. A legitimate concern for New Zealand's inadequate growth performance should focus systematically on growth issues.

- There are no clear grounds for government efforts to alter people's consumption and savings choices, given a policy environment in which choices are distorted as little as possible.
- Tax incentives and compulsory savings proposals in particular should be rejected as ineffective, distorting, inequitable and illiberal policies. As one researcher has put it: "[S]aving-inducing tax plans are attacking a problem that does not exist with a mechanism that will not work in order to achieve a goal that would harm the economy".[10]

Rather, the debate in New Zealand should move on from concerns about macroeconomic savings aggregates to issues such as levels of spending and taxation and the boundaries between state and private responsibility for the provision and funding of social services, including retirement incomes. The purpose of this debate should not be to engineer particular levels and forms of savings but to improve economic incentives, encourage more efficient savings and investment decisions, and enhance overall economic and social performance.

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10 Neil Buchanan (1999), *Journal of Economic Issues*, March, Vol 33, No 1, March, pp 59–76.

MISCELLANEOUS

THE AUCKLAND CLUB

THE NEW ZEALAND BUSINESS ROUNDTABLE: SAME PRINCIPLES, NEW DIRECTIONS

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NEW ZEALAND BUSINESS ROUNDTABLE

AUCKLAND
11 JUNE 2002

THE NEW ZEALAND BUSINESS ROUNDTABLE: SAME PRINCIPLES, NEW DIRECTIONS

A business organisation recently described itself in the following terms:

> [We are] a non-party political organisation – but one that is committed to freedom of choice, free and competitive markets, minimal state intervention, low taxes and business-friendly regulation.

It said it had been committed to outlining its policy aspirations on economic and business issues even-handedly to any political party that would listen. "And we still are", it said. "So please listen."

No, the organisation was not the New Zealand Business Roundtable, but it could have been. It was the Institute of Directors (IOD) in Britain. The IOD was recently described as being "almost a lone voice" in the community in warning that tax rises and a significant increase in regulation, especially labour market regulations, were threatening Britain's competitiveness and its economic performance.

Also in the news in Britain recently was that country's largest business organisation, the Confederation of British Industry (CBI). Its style of operation has been described as "doing deals with Whitehall rather than promoting the wider cause of industry". The implicit bargain was that ministers would talk to business and, in return for influence, business would refrain from criticism and confrontation. On coming to office the Blair government conducted a 'prawn offensive' with business, spoke endlessly about 'enterprise', and selectively bribed industry with handouts. But, to the CBI's consternation, the recent British budget savagely increased business taxes, causing the CBI to cry betrayal and commentators to question how much influence the CBI really has.

The spectacle of business representatives, trade unions, environmental organisations or welfare lobbies being in bed with governments – or with any political party – is never very edifying. Seldom is the public interest served by such associations – they usually serve narrow interests at the expense of the general community. Business organisations have a duty to engage with governments but, in my view, they should maintain their independence and integrity and express their views without fear or favour. Apart from anything else, governments change and parties change their policies. If the arguments of business organisations on a particular issue are sound but are rejected at first by a government, they may just have to keep trying and bide their time.

From its inception the Business Roundtable was determined not to operate on the principle that 'What's good for General Motors is good for America'. In the past, business organisations in New Zealand had typically lobbied for their own narrow interests, and the legacy was a highly distorted, slow-growth economy. By contrast, we have favoured no import licensing or tariff protection, no export subsidies, no selective tax breaks for businesses, no barriers to competition in domestic markets, and no protection of listed companies against takeovers. Leaders of businesses that benefited from these privileges in industries like manufacturing and liquor were in the forefront in arguing against them, despite the fact that their removal wiped millions of dollars off the value of their companies. We have taken an overall national interest perspective that turns the General Motors one on its head, and argued that what's good for the whole community is good for the business sector at large in the long run.

Such a stance is untypical of business organisations, and many have found it hard to come to terms with. Vested interests, ranging from monopoly unions to monopoly producer boards, have felt threatened, many people have looked for ulterior and self-serving motives, accusations of undue influence and corporate greed have flown freely, and there has been plenty of playing the man rather than the ball. There is no way of dealing with such criticisms other than by patiently responding with facts and arguments. Ultimately, sound ideas tend to win out.

Let me give you one example. In the early 1990s, dairy industry leaders were calling our arguments for reform of the industry ignorant and theoretical, and many farmers accused us of wanting to strip them of industry control. By the end of the decade, the agriculture editor of the *New Zealand Herald* was writing:

> The Roundtable has to be acknowledged for in the past accurately highlighting the industry's failings and providing remedies that have since been reluctantly swallowed.

This outcome is a good illustration of John Maynard Keynes's dictum that "the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas".

Producer board reform is also a good example of how sound ideas become non-political, which is the same as saying they become accepted by the community at large. Towards the end of its term of office, the National Party, which had dragged its feet on the issue for years, came to accept the logic of the arguments for change. With the change of government, Jim Sutton, to his credit, took over where National had left off and accelerated the process. There is still some unfinished business but there is no turning back, given the changed attitudes of most of those directly affected.

At a broader level, it is also clear that there is no turning back on the general thrust of New Zealand's economic reforms of the past 15 years. The current government has maintained most of the core elements: the Reserve Bank of New Zealand Act 1989, the Fiscal Responsibility Act 1994, the State Sector Act 1988, the open economy, deregulated markets, the goods and services tax, most privatisations and, despite some changes, even the freer labour market and the welfare reforms. These are all changes we advocated, often in the face of fierce criticism. I suggest they have been kept in place not for any ideological reasons but because the public at large understands that overall the reforms were necessary, and it supports them. What we and others have been concerned about for several years is not that New Zealand's post-1984 economic framework is under threat but that little has been done to strengthen and extend it, and that most recent changes – producer board reforms being one exception – have been directionally wrong.

How can this debate be constructively advanced in the period ahead? The main political parties are all acknowledging the need for the country to do better. We have been saying that the government's present policy settings will not achieve its commendable goals of restoring New Zealand to the top half of the OECD income rankings, and we think the evidence supports our view. Last month's budget suggests annual economic growth will average only around 3 percent over the next few years, and then fall away to a bit over 2 percent. More successful countries are continuing to implement market-oriented policies. As I see it, there are no left-wing or right-wing economic policies today – only good and bad ones.

The Business Roundtable is in some ways a think tank, and the ideas coming out of think tanks around the world illustrate this point. In the United States and Britain, 'centre left' think tanks such as the Brookings Institution, the Progressive Policy Institute (PPI) and the Institute for Public Policy Research (IPPR) espouse policies, in a number of areas, that are very similar to those we have advocated for many years in New Zealand.

Education policy is a good example. The PPI, which is aligned to the Democratic Party in the United States, supports revamping teacher certification rules, increasing school choice through charter and contract schools, and rethinking teacher pay arrangements – an issue of some interest in New Zealand these days. A recent PPI report by Bryan Hassel argued that:

> It's time to move beyond a pay method designed early in the last century and to begin building an innovative system that addresses the realities of public schools in the 21st century.

The report went on to argue for a range of reforms to teacher employment arrangements, including paying more to teachers in certain disciplines and in hard-to-staff areas, paying for demonstrated knowledge and skills rather than only experience and degrees, tying rewards to student learning, and giving school leaders more authority to set teachers' pay.

In Britain, a recent IPPR report by Wendy Piatt and Peter Robinson recommended a reduction in subsidies to tertiary education and the introduction of market interest rates within the UK student loan scheme on the grounds that the current subsidy levels to tertiary education benefit primarily the middle classes.

Given that the Business Roundtable has long advocated similar positions in New Zealand, it is hard to see where the right wing ends and the left wing begins.

Clive Hamilton, director of the leading left-wing think tank in Australia, the Australian Institute, recently told a Labor Party gathering that:

> Since the early 1980s, many of us have been searching for a coherent alternative to neo-liberalism, for a way of reinventing social democracy in an era of global consumer capitalism … We have failed miserably. So bereft of ideas has the Left been that the vacuum has been filled by the pallid apologetics of the so-called Third Way … We must face up to the facts of today's world … while rooted in historical fact, the Left's deprivation model is today the opposite of the truth. By any standard Australia is an enormously wealthy country.

Though coming from an unusual quarter, this view is still far from universally accepted in Australia. When the Business Council of Australia (BCA), our counterpart organisation, was supporting the goods and services (GST) debate in that country I noticed an attack on it that could have appeared in any New Zealand newspaper. The critic wrote:

> After a decade of 'reform', large sections of the community are yet to see any real benefits. What they have seen is unemployment, withdrawal of services, insecurity and social demise, and on the other

> hand huge corporate profits and an increasing wealth gap. They rightly ask – what are we reforming and why?

This is a minority view, and not supported by the facts – the Australian economy has performed very well in the last 10 years and the benefits have been widely shared. Nevertheless, the BCA is deeply concerned about the entrenched anti-business streak that still exists in the Australian psyche, and the tendency always to suspect the motives of big business and its leaders. Its president, John Schubert, recently said that the BCA believed its central task today was as much talking to the person on the street as talking to politicians:

> We think there is a task to build a cultural understanding and support for the private enterprise economy system … We understand this brings with it obligations for our members and for all business, but if Australia is to reach its potential we must have a dynamic, well-respected and well-understood private sector capable of paying higher wages and employing more people.

The Business Roundtable has always spent less time than the BCA lobbying politicians and has concentrated more on promoting policy arguments and public understanding. However, we have similar concerns about anti-business attitudes in New Zealand and negative perceptions of our role. We are troubled by the country's modest economic aspirations, the complacent belief that the economy is in good shape, and the apparent lack of willingness to face the challenges of doing better.

Perhaps the most important things the country is lacking are the right attitudes and values. Too many New Zealanders, it seems, are in doubt about the importance of economic growth.

Many people see growth as the enemy of the environment, social equity and fairness. It is not. The most vulnerable in society are generally best cared for in wealthy countries. Poverty has never been kind to the environment; poor countries do not have good environments. Wealthy market economies on the other hand tend to prize their environments and take good care of them.

There needs to be wider understanding that growth is about giving people choices and options; about ensuring that our kids get a world-class education and don't need to leave for better jobs abroad; about not having to go to Sydney for an operation; about having a decent retirement.

To achieve these outcomes our economic policies need to be not just as good as those of our competitors, which have advantages such as larger markets or greater proximity to centres of population. Our policies need to be better. New Zealand needs lower taxes, fewer obstacles to doing business and significantly better education in order to stand out and attract investment.

We have consciously decided to put more emphasis on getting these messages across to wider audiences, engaging with others who share our concerns and goals, and communicating more directly with workers, consumers and taxpayers whose interests we have always seen ourselves as promoting.

We will remain a research-based advocacy organisation, but we are reorienting our research programme to underpin our communications efforts. Thus, a recent study of Tasmania was undertaken to illustrate the risks to New Zealand of being a slow-growing, government-burdened, Green economy. Our next study addresses myths surrounding privatisation. Others this year look at broad issues affecting the family as an institution and at the education system. We want to find ways of engaging more with teachers – their working lives in the present state-dominated system are being made as miserable as the deal it delivers to parents and children.

One sector we want to connect more closely with is small business. Many small business people perceive the interests of the corporate sector to be remote from theirs. This is not the case – both struggle with things like tax burdens, business regulations and bad employment law. We have never carried a special brief for big business – every large business was once a small business. The organisation is only structured the way it is in order to enable busy chief executive officers of large organisations to take an interest in national affairs. We want New Zealand to have efficient businesses, capable of growing and employing more people, irrespective of their size. We are doing a study on obstacles to business growth in New Zealand that will illustrate the common concerns with the small business sector.

We want to identify more closely with Maori business and other interests. Maori are playing an increasingly important role in New Zealand business. Several current and past Business Roundtable members are Maori, and we would like to have more. I spoke recently to a Ngati Kahungunu economic summit. We are focusing on many of the same issues as the Federation of Maori Authorities. Much of the work we have done on employment, education and welfare has a direct bearing on Maori interests.

We are revamping our website www.nzbr.org.nz, which already gets a lot of traffic, to make it a more effective communications tool. All our studies, submissions, speeches and other material go up on the site, and we are planning other series such as a set of policy backgrounders for students and journalists.

For many years we have brought speakers to New Zealand to share their insights on topical issues, and we are looking for future visitors with broad appeal. This year Francis Fukuyama, author of *The End of History* and *Trust*, will be giving our annual Sir Ronald Trotter Lecture, and a visit by American writer and humorist PJ O'Rourke is planned.

The media are very important in any communications enterprise and, despite the flak we get from some commentators, we feel we generally get good and fair coverage. One new planned initiative is to establish a scholarship to mark the contribution of one of our former chairmen, Douglas Myers, to public affairs. This will enable one or more journalists each year to spend time overseas studying areas of public policy that are relevant to New Zealand.

We have long had excellent relations with other national business organisations and we are always keen to have leading business people join us as members. There are still too many who have benefited from the changes in the economy, or who would benefit from future improvement, who do not pull their weight in national affairs.

The common theme in all this is that it is the electorate at large, not any particular group of politicians, that will determine where the country goes. Leadership in politics is a prized commodity, but more often politicians reflect the electorate rather than lead it. Arguably the most important event in New Zealand politics today is the decline of the Alliance. This reflects a huge change in voters' thinking: 20 years ago almost all New Zealand political parties espoused Alliance policies. The electorate has come to understand that they are not a recipe for success in today's world. Improving public understanding is the only way of achieving better policies on a stable and durable basis.

Thus, the important thing for us is not whether we are onside or offside with governments at any point of time. We try to maintain constructive relations with both governments and opposition parties, but we have had disagreements with both sides in the past and I dare say we will have others in the future. For us, what is important is that we come up with sound, reasoned arguments as to what is in the country's best interests, and that we persuade people on their merits. At the end of the day, the democratic process will decide which get picked up, which is as it should be.

It follows that if New Zealanders opt to vote for policies of state favours to interest groups, redistribution and slow economic growth, that choice has to be respected. At least in today's world, enterprising people and businesses can pursue their goals elsewhere. I doubt, however, that most New Zealanders would consciously choose a future in which wealth and talent are drained offshore and other countries continue to pass us by. Avoiding it requires greater public understanding of policies that make for economic and social success, and greater public pressure on all political parties to adopt them. New Zealand is still clinging to institutions and practices that make people poorer and state-dependent rather than wealthier and free. We are refocusing our efforts on the public understanding and debate that is needed to provide a platform for decisions that will take the country forward.

ROTARY CLUB OF NEWMARKET

IN DEFENCE OF FREE ENTERPRISE

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

AUCKLAND
19 MARCH 2002

IN DEFENCE OF FREE ENTERPRISE

The widespread protests, even spilling over into violence, that have accompanied meetings of international organisations and world leaders constitute one of the more worrying developments of our times. Some of the protestors are voicing legitimate concerns about the operation of international institutions. But most of the protests against 'globalisation' are based on little more than ignorance, half-truths and dangerous illusions. Whatever their intention, the prescriptions of the protesters would harm people in all countries, and especially the poor. Above all, they would seriously harm people living in the poorest countries on the planet. That amounts to a rather rich irony – an irony not lost on a recent Mexican president, who after one round of protests commented:

> ... forces from the extreme left, the extreme right, environmentalist groups, trade unions of developed countries and some self-appointed representatives of civil society, are gathering around a common endeavour: to save the people of developing countries from ... development.

Because the debate about globalisation is an extension of the debate over free enterprise generally, I will begin by discussing the compelling case for free enterprise. Given the demonstrated success of market systems in generating and spreading prosperity; the explosion of wealth creation and new technological invention 200 years ago in free-enterprise Britain in the form of the industrial revolution; the extraordinary post-war success of free enterprise economies such as Hong Kong and Singapore; the dismal failure of most of the experiments in economic planning; and the huge and ongoing increase in wealth worldwide, powered largely by free enterprise, it may seem strange that the case for free enterprise needs to be made at all. But it does need to be made, time and again.

The fundamental principle of free enterprise is mutual gain through exchange. Every market transaction involves two or more parties who expect to be made better off by proceeding with it. Each possesses something they are prepared to part with, and values it less highly than the good or service received in exchange. Mutual benefit through exchange is at work whenever one party is selling the other a newspaper or a car, giving them a loan to buy a house, or paying them wages to perform a given job. Welfare accrues to both sides – the seller of the newspaper as well as the buyer, the employer as well as the worker. One party does not hog all the gains, with the other party vainly hoping that some of those gains will 'trickle down' to them. Welfare is being jointly created many times every day in a myriad of transactions. Fundamental to this process is secure property rights, so that people can buy, sell, or use their property as they see fit. Also fundamental is freedom to contract – a liberty often severely curtailed by misguided or oppressive governments in many parts of the world.

The key to reaping the full benefits of free enterprise is competition. It is competition that prevents one party from driving too hard a bargain, and gives people on all sides of the market options. Competition also provides much of the spur to innovation. Nobody will buy a car from one supplier if an otherwise equally good car available from a different supplier is cheaper, or has more features, or is preferable in some other way. Nobody will work for one employer if a job can be found down the road that pays higher wages, or has better working conditions, or more convenient hours, or is in some other way more suitable.

The evidence is overwhelming that countries whose governments place high priority on upholding property rights and freedom to contract; that restrict themselves to providing the comparatively small number of goods likely to be inadequately provided by a market, such as defence and public health; that keep taxes low; and that resist the many false temptations to 'improve' on the market – such as diverting taxpayers' money to selected industries, imposing import protection, or starting up new government banks – reap huge benefits in economic growth, and thus in living standards. Higher growth does not just mean more to spend on a narrow range of consumer goods. It also means more resources for health, education, the environment, sport and recreation, the arts, and indeed anything else valued by people.

The positive relationship between economic freedom and prosperity is now very firmly established. The Cato Institute is an American think tank that ranks countries by their degree of economic freedom. In a recent study of 123 countries it concluded that:

> There are astounding differences in economic and social outcomes between nations that are more economically free and those that are less free. Life expectancy is 20 years longer for people in the 24 most free countries (the top fifth) than in the 24 least free countries (the bottom fifth). Average income per person in the top fifth was US$18,000 in 1997, compared to less than $2000 for the bottom fifth.

Yet despite incontrovertible evidence in its favour, myths about free enterprise abound.

One myth is that free enterprise puts the interests of business above those of consumers or the wider community. Yet the truth is the complete opposite. The consumer is sovereign in a market economy, and the greater the degree of competition the more thoroughly sovereign the consumer will be. Companies that cannot match their competitors in serving the needs of consumers can – and often do – make terrible losses or go out of business altogether. The interests of consumers are sidelined only when policies are adopted that shield some businesses from legitimate competition, or discriminate in favour of certain sectors.

Another myth is that free enterprise favours big business as against small business. But there is a role for both large and small enterprises in a market economy. A corner dairy and a large supermarket chain can both survive and flourish, provided each is meeting a need. A good government will not wish to favour one over the other. Worldwide, the trend is for businesses to become smaller on average, not larger.

Again, it is said that free enterprise promotes selfishness, undermines cooperation, and weakens social relationships. But a market economy is a vast network of cooperation. We have already seen how voluntary cooperation is its very essence. Two people cooperate when one sells the other a carton of milk. And within a large company, many people cooperate in the course of producing and delivering goods or services.

A surprisingly prevalent myth is that most social and economic indicators are deteriorating around the world – that life is getting harder, that things are growing worse globally and that free enterprise is responsible for these trends. Yet the facts tell a vastly different story. Despite all the short-term ups and downs, the world as a whole is growing healthier, wealthier and, if not wiser, at least better educated in the sense of more young people completing their schooling and going on to higher education. Economic growth is maintained in most countries, life expectancy continues to increase, tyrants are toppled as democracy and human rights gradually spread, under-nourishment in developing countries continues to fall, illiteracy rates decline, and new technology finds better ways to satisfy human needs.

Needless to say, not all the trends are positive. Crime has risen in many countries over the past generation and technology has the power to wreak terrible destruction, as well as to do good. The appalling acts of terrorism committed against the United States bear eloquent testimony to that fact. Yet, however shocking those events, we humans have displayed a capacity in the past to rise above setbacks and move forward – not invariably, but on most occasions on which we are tested.

'But all this so-called progress is only occurring through increasing global inequality', is the constant refrain. Not true. Over the past three decades economic growth in developing countries has averaged around 5 percent per year. In the developed world it has averaged only 3 percent. Of course, not every developing country has grown strongly, or even grown at all over that period. A few developing countries have gone backwards, and many of their citizens remain desperately poor. Thus, the gap between the richest and the very poorest countries has widened. But it would be absurd to blame that state of affairs primarily on the rich nations. Almost all the poorest performers are countries mired in corruption and over-government, where the essentials of secure property rights, a legal system upholding contracts, and a substantial degree of economic freedom are largely absent. From North Korea to Myanmar, from Albania to sub-Saharan Africa, bad government plays a role in almost every sad story.

'But our current levels of economic growth are not sustainable', comes another objection. 'The population explosion, and pressure on resources, will soon bring development to a halt'. There is no more truth in this assertion than in any of the other myths. Indeed, it is a very old refrain: doom-mongering about the unsustainability of present levels of development has been around for almost as long as we have had development. And generation by generation the doom-mongers have been proved wrong. Many of us remember the 1972 Club of Rome report, according to which the world would by now have completely run out of petrol, natural gas, copper, lead and virtually every other important mineral. For a time that report seemed to be the conventional wisdom. But the lurid scenario did not eventuate.

Around the same time there were also apocalyptic predictions of widespread starvation and other dire consequences of overpopulation. They have also been totally confounded by events. Per capita food production has continued to rise worldwide: despite increasing numbers, land has continually become more productive. Ironically, famine has recently been confined mainly to thinly populated Africa, where its causes have been drought combined with egregiously bad government. Meanwhile, alarmist predictions about the effects of population growth were taken so seriously in some quarters that China introduced its policy of one child per family – a highly illiberal measure that nobody in the developed world would remotely want for their own society.

The basic mistake made by all the 'sustainability' doom-mongers has been to underestimate the ability of the human mind to find alternatives in the light of the signals sent by market prices. If a resource becomes scarce, its price rises. That will set off a search for alternatives. Consumers of the resource have an incentive to economise on it. Producers have an incentive to come up with substitutes. As leading economist Paul Romer has put it:

> Every generation has perceived the limits to growth that finite resources and undesirable side effects would pose if no new recipes or ideas were discovered. And every generation has underestimated the potential for finding new recipes and ideas. We consistently fail to grasp how many ideas remain to be discovered. The difficulty is the same one we have with compounding. Possibilities do not add up. They multiply.

Almost by definition, we cannot predict what has yet to be discovered. If we knew where the next bright idea was coming from, it would already be known. Even famous scientists have frequently made dogmatic pronouncements about what was possible or impossible that looked rather silly to later generations.

Yet another myth is that free enterprise and globalisation are taking an unacceptably high toll on the natural environment. In fact, the natural environments of the rich countries have generally been improving in recent decades. Examples of serious environmental degradation have been much more common in the developing world, including some well-documented horror stories in ex-communist countries. Advanced, free enterprise societies have two advantages over developing countries in dealing with environmental problems. Our greater wealth enables more resources to be devoted to the natural environment. And societies such as ours have the political and institutional mechanisms – such as a free press, freedom of association and the rule of law – for mediating the often-complex tradeoffs between economic and environmental goals.

In the litany of objections to 'globalisation', many of the myths already discussed are retailed, with some new ones added. To defenders of free enterprise they sometimes seem like the many heads of the hydra-headed monster that confronted Hercules in Greek legend: when Hercules chopped off one head, two more grew in its place.

If by 'globalisation' we mean lower barriers to trade, to financial flows, and to direct investment, all thinking people should be in favour of globalisation. Recall that the essence of free enterprise is voluntary exchange for mutual gain. International trade is an important means by which these gains can be extended. Through trade, a country specialises in producing goods or services in which it has a comparative advantage. By exporting those goods, the country effectively exchanges them for goods in which that country does not have a comparative advantage. In other words, international trade enables a country to reap the benefits of specialisation. And it is achieved through households and firms all making their own individual decisions: no central planner is necessary or desirable. The simple but powerful principle of comparative advantage, first articulated 200 years ago, has been supported by a huge amount of subsequent evidence on the benefits of free trade. Yet still there are many voices calling for 'fair' trade, 'managed' trade and various other forms of protectionism, using arguments that simply do not stand up to examination.

One myth about globalisation is that such a process is irreversible. But history tells us that weak and muddleheaded governments are perfectly capable of putting up new barriers to trade. In the 1930s, politicians in Europe and in America listened to the siren calls of those on both sides of the Atlantic wanting higher import protection, supposedly to preserve jobs, support industry, provide fairness, and so on. The catastrophic trade war that followed helped turn an ordinary recession into the Great

Depression, with millions thrown out of work, enormous social stress and the grim aftermath of the rise of Adolf Hitler.

In the post-war period many countries, from India to New Zealand, suffered from misguided approaches to ‘development’ in which local industry was ‘encouraged’ by high protective barriers. Lack of competition led typically to gross inefficiency and increased costs right through the economy. Some protected businesses were winners, but ordinary households lost out badly. Nor is there any evidence that overall employment levels have ever been helped by import protection. Some countries, such as Cuba, have suffered from isolation as a result of a policy imposed by others: their economies are in a terrible state. Of course in the eyes of some critics the United States just can’t win. It is blamed for not trading with Cuba – the trade embargo. And it is blamed for trading with other third world countries – which is apparently ‘exploitation’.

Another myth is that the poor are left behind by globalisation and free trade. A comprehensive study by two World Bank authors found no evidence of the bottom 20 percent of households falling behind, whether in developed countries or developing countries. But the World Bank study did find openness to trade to be beneficial. It concluded:

> … the basic policy package of private property rights, fiscal discipline, macro stability, and openness to trade increases the income of the poor to the same extent that it increases the income of the other households in society.
>
> This is not some process of ‘trickle down’, which suggests a sequencing in which the rich get richer first and eventually benefits trickle down to the poor. The evidence, to the contrary, is that private property rights, stability, and openness directly create a good environment for poor households to increase their production and income.

Various myths about international trade continue to circulate. There is the simplistic idea that exports are somehow good and imports bad. This view sees one country as ‘winning’ if it runs a trade surplus with another country, but ‘losing’ if it runs a deficit. But once we have grasped the fact that in international exchanges both parties gain, any such idea evaporates. New Zealand could run a trade deficit with one country and a surplus with a third country, and all three would be winners under free trade. Then there is the myth that competition from poorer countries pushes down the wages of unskilled labour in rich countries. There is some evidence of rising inequality of incomes in rich countries, but little evidence to link this trend to competition with third world labour. Technological change appears to be the main factor.

Finally, multinational corporations are said to ‘exploit’ workers in poor countries. But workers in these countries are not stupid, nor are they wholly without options, grim as their situation may sometimes seem to affluent westerners. They work for a particular multinational company because they judge it to be better than the alternative. The alternative may be a worse job, perhaps no job at all, starvation or prostitution. Provided they operate in good faith, multinationals clearly benefit workers in poor countries. There is evidence that multinationals tend to pay higher wages than local industry.

Trade more generally is by far the best means by which people in the rich countries can help the poorest of the poor to increase their living standards. It is thus a serious moral error for Western nations to erect tariffs and other protective barriers against poor countries. Such barriers harm these countries much more seriously than any amount of foreign aid can ever compensate for. Politicians in New Zealand who support such policies stand condemned, just as much as politicians abroad. Economist Paul Krugman has stern words for this type of woolly-minded thinking:

> You may say that the wretched of the earth should not be forced to serve as hewers of wood, drawers of water, and sewers of sneakers for the affluent. But what is the alternative? Should they be helped with foreign aid? Maybe – although the historical record of regions like southern Italy suggests that such aid has a tendency to promote perpetual dependence. Anyway, there isn't the slightest prospect of significant aid materialising …
>
> As long as you have no realistic alternative to industrialisation based on low wages, to oppose it means that you are willing to deny desperately poor people the best chance they have of progress for the sake of what amounts to an aesthetic standard – that is, the fact that you don't like the idea of workers being paid a pittance to supply rich westerners with fashion items.
>
> In short, my correspondents are not entitled to their self-righteousness. They have not thought the matter through. And when the hopes of hundreds of millions are at stake, thinking things through is not just good intellectual practice. It is a moral duty.

NEW ZEALAND–HONG KONG BUSINESS ASSOCIATION

NEW ZEALAND AND THE OUTSIDE WORLD

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

HONG KONG
10 DECEMBER 2001

NEW ZEALAND AND THE OUTSIDE WORLD

I am delighted to be here this week as a guest of the Hong Kong government, and to renew contacts with one of the dynamic hubs of the Asia Pacific region. And I am, of course, very pleased to be the guest of your Association today and to speak on the topic 'New Zealand and the Outside World'.

When you think about it, you probably couldn't make a speech on the topic 'Hong Kong and the Outside World'. It wouldn't make much sense given that the outside world is so much part of the fabric and the success of Hong Kong. You have built a thriving society on the idea of openness to the world.

For many years Hong Kong has been the best example of a free and open economy. I noted that your government recently described 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]

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.

There are lessons for others in Hong Kong's record of economic management. For example, there is much to be said for Hong Kong's tax scale, which is close to a flat rate. A recent government review concluded that New Zealand should be moving to a lower, flatter income tax structure.

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

Hong Kong has embraced free trade because of your position at the crossroads of Asia – the world passed through your doorways and you took full advantage of your location. New Zealand came to the same conclusion but for the opposite reason – because of our geographic isolation. No-one came knocking at our doors – except for a relaxing holiday. So, for many years, we have been a leading advocate of freer trade in order to obtain better access to world markets and to make our own industries more efficient by exposing them to competition. In recent years we have reduced our tariffs unilaterally – that is, without necessarily seeking reciprocity. This caused initial consternation, but the sky did not fall in and our formerly protected industries are now far more productive and export-oriented.

For New Zealand, most of the outside world is still a long way away. However, since the time I was directly involved in New Zealand's external relations in the late 1960s and early 1970s, New Zealand's international engagement has changed profoundly. The country has built up a remarkable network of strong and durable relationships and connections, all designed in significant part to further our economic prosperity and expand our trade and business opportunities. Not least of these have been in North East Asia. Complementing our bilateral relationships has been a strong commitment to the multilateral economic agenda. Like Hong Kong, New Zealand is regarded as a serious participant in both the World Trade Organisation (WTO) and the Asia Pacific Economic Cooperation (APEC) forum.

We have built up a reputation as a steady, innovative member of the international community. Lee Kuan Yew has said "You know where you stand with New Zealanders – they don't jump around". Lee also once said to David Lange, on Lange's first visit to Asia as prime minister, "If Singapore is the odd man out in Asia, New Zealand is the odd man in". It was a nice tribute to our standing in this region. That New Zealanders are currently heading both the WTO and the Commonwealth Secretariat is some sort of indicator of our international reputation.

New Zealand is still a major primary industry producer, and I see no cause for concern in that. The world is going to want a lot of food, fibre and forest products over the next 50 years. We should forget the notion that agriculture is not conducive to economic growth. Over the past 20 years productivity growth in agriculture in New Zealand has been nearly 4 percent annually – much faster than in most other industries. Well, it might be said – so much for the rest of the economy. As some of you may know, I have some views on that topic, but this is not the time and place for them.

Talking about international engagement brings me, inevitably, to September 11. There is probably nothing to say that has not been said before. The attacks on the United States brought the outside world closer to us all. There was no disposition in New Zealand to turn our isolation to account. On the contrary, the government's response took New Zealand straight into the unofficial coalition that reflected the overwhelming international commitment to counter terrorism, both immediately and over the longer term.

Have the events of 11 September fundamentally changed the international system? My own view is that they have not. There has been a successful APEC Summit in Shanghai and the successful WTO Summit at Doha. The impact on the developed economies has been immediate and inevitable – but surely not profound. All our economies have taken a knock, and at a time when they were coming under some cyclical pressure. But I do not see it as more serious than that.

Ironically, the events seem to have had some positive outcomes. The Bush administration has turned away from the unilateralism that seemed to characterise its early pronouncements on foreign policy. The international response to terrorism has moved Washington's engagement with Moscow and Beijing to a new level. And, as one small part of this, New Zealand's response seems to have done something similar for Wellington's relationship with Washington.

For New Zealand, an especially important area of the outside world is North East Asia. Five of our top 10 economic relationships are in this region – China, Japan, Korea, Hong Kong and Taiwan. These relationships are highly valued. New Zealand has worked assiduously on them since the 1970s.

Time does not allow me to refer even briefly to all five relationships. But, I should note that for New Zealand, as for so many other countries, nothing on the international agenda is more important than that the Chinese government and people continue steadily on the remarkable journey that they began in 1979 under Deng Xiao Ping. China's steady moves towards a market system are changing the face of the world economy. Its entry into the WTO this year is another landmark on the journey. New Zealand's relationship with the People's Republic is in excellent shape. Both the prime minister and the foreign minister have made successful visits to China this year.

I need not examine the relationship with Hong Kong – the Association has had speeches on this by prominent New Zealanders earlier this year. I will, however, mention the value that the New Zealand business community attaches to the negotiations currently under way to conclude a Closer Economic Partnership (CEP) between New Zealand and Hong Kong. This will be a 'state of the art' free trade agreement (FTA) similar, I understand, to the CEP New Zealand concluded with Singapore last year – to the surprise of many in our region and beyond. The Singapore CEP was a pathfinder – more important in that respect than for what it held for the signatories (although it did open up a hitherto closed services sector to New Zealand professional services companies). It is notable that Australia is now hoping to conclude a similar agreement with Singapore.

The Hong Kong CEP is also, in part, designed to serve as an encouragement to others – not least to APEC as a whole as it begins to focus on its Bogor goals of 2010 and 2020. New Zealand is positive about consummating FTAs with just about all comers. The big prize is the United States. Australia is hoping to turn its special relationship with the United States to account and to negotiate an FTA with Washington. If this happens, it will be almost inconceivable that New Zealand will not at some stage be included, given the direct relevance of our own free trade agreement with Australia.

These country-to-country FTAs do not, in my view, cut across the supreme importance of the multilateral global trade and services agenda of the WTO. They are a valuable accompaniment to it, as are regional arrangements such as the ASEAN Free Trade Area (AFTA) and the North American Free Trade Agreement (NAFTA). These must not, however, be regarded as a substitute for comprehensive liberalisation. The European Union is the prime example of the baleful and distorting effects of protectionist regional arrangements. New Zealand's CEP policy is light years away from Brussels.

In conclusion, let me briefly list what the New Zealand corporate sector sees as the key elements of New Zealand's all-important relationships with the five North East Asian countries. They are trade, investment, tourism, immigration and education. It is critical that New Zealand's policies in these five fields produce the right dividends for us and for our North East Asian partners.

I have already covered trade. The New Zealand business community thinks our government's energetic and imaginative approach is along the right lines. For New Zealand – and for Hong Kong – the trading world might be our oyster, but it takes a lot of work to prise it open.

New Zealand is starting to promote investment better. But much remains to be done if we are to be seen as attractive as Australia – and it is only realistic to see Australia as our direct competitor here. It will be difficult, given the relatively small size of our enterprises, to attract the serious interest of many Asian investors. A key issue for New Zealand is to improve its overall economic performance by continuing to upgrade its policy framework – we need to do more to stand out from the crowd. We also have to be more active and targeted in our promotion. I would welcome your views on this. It is concerning that despite some good work by Gary Langford in Trade New Zealand on the venture capital front, the results to date have been slim. I would like to see a joint venture capital fund established in Auckland by a group of Hong Kong or Taiwan venture capital companies. The returns would be fully in line with international standards. It is interesting to note that in New Zealand our own venture capital companies are starting to expand and write some highly profitable business.

As to tourism, the government and the industry are devoting significant resources to international promotion, with some good returns. New Zealand has so much to offer the Asian tourist but the promotion needs to be more effectively and precisely targeted. Germans love skiing over cliffs. Sensibly, Asians do not.

On immigration, we must settle on a flexible, attractive policy and stick with it. The aftermath of the sudden shift and tightening in the mid 1990s is still dogging New Zealand in Asia. This cut across Lee Kuan Yew's dictum about steady New Zealanders, and we have been paying for it. New Zealand is short of skills and of entrepreneurs. Asia has plenty of them. It was pleasing to see last week the introduction of a Talent Visa with attractive inducements to work in New Zealand. Migrants are an investment – we must look after their needs much better than we have to date.

Finally, we must also do a better job on education. There seems to be a disappointing lack of coordination among the official agencies involved, and between them and the New Zealand educational institutions. Australia is operating much more effectively. Again, I would welcome your views on this and on immigration.

In sum, New Zealand has a highly effective track record in the outside world in a general sense. We are well and extensively connected where it counts – not least in East Asia. But on some of the concrete specifics we could do better in this region. And we must keep on keeping on making our economy more competitive and attractive as a place to invest, work and do business. There are many lessons – in fields ranging from tax to education to welfare – that Hong Kong and other Asian countries can teach us to help with this project.

ACT NEW ZEALAND NORTHERN REGIONAL CONFERENCE

FREEDOM AND PROSPERITY

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

AUCKLAND
17 NOVEMBER 2001

FREEDOM AND PROSPERITY

My topic is the economic dimension of freedom. Conceivably, freedom and prosperity could be at odds. In that event most of us would prefer to live in a free country – a country with civil and political freedoms – even if it meant accepting a lower standard of living. Happily, economics teaches us that freedom and prosperity are not only compatible but mutually reinforcing.

Historically, many prominent writers and thinkers detested the teachings of economics, as well as liberal ideas generally. Indeed, the much-quoted description of economics as "the dismal science" was coined by Victorian writer Thomas Carlyle in a debate over slavery with the economist and philosopher John Stuart Mill. Mill opposed slavery whereas Carlyle campaigned to maintain it. Carlyle wanted a hierarchical social order: he also campaigned against democracy and the spectre of feminism. From Adam Smith to Mill, the classical economists were among the leading reformers of the Victorian age whereas Carlyle, Ruskin, Kingsley and Dickens were among the reactionaries.[1] The elitism of many of the literati hasn't changed much down the years.

As the slavery example illustrates, freedom – economic, political and civil – is an end in itself, not a means to an end. We would abhor slavery even if it were a more productive economic system. But economic freedom is also an indispensable means of achieving other freedoms. Milton Friedman cites the case of British citizens who could not spend a vacation in the United States after World War II because of exchange controls. Their freedom was no less restricted than that of US citizens unable to visit the Soviet Union because of their political views. While the first restriction was ostensibly an economic limitation on freedom and the other a political limitation, the practical results were essentially the same.[2]

In another example that is relevant to the debate about compulsory superannuation in New Zealand, Friedman points out that US citizens who are compelled by law to devote around 10 percent of their income to a particular form of retirement saving are being deprived of a corresponding part of their personal freedom.[3] New Zealand apple growers who, until last month, were prohibited from freely selling their produce to a willing overseas buyer – and a few years ago even to a New Zealand buyer – were similarly deprived of a basic freedom. Indeed, the ability to trade on mutually acceptable terms with anyone around the world is ultimately an issue of morality and freedom. So-called globalisation is not a phenomenon engineered by governments: it is simply what happens when people are free to invest, trade, derive cultural enjoyment and, increasingly, work in other countries around the globe.

Clearly, it is possible to have economic freedom without civil or political freedoms. Hong Kong as a British colony was one of the freest economies in the world with a great deal of civil freedom but no political freedom. Nevertheless, economic freedom is a necessary if not sufficient condition for political freedom – there are no examples of politically free countries that have not relied essentially on private enterprise economic arrangements. Economic freedom tends to facilitate political freedom, as

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1 See Terry Arthur (2001), 'Economics, Slavery and Victorian Reformers', *Economic Affairs*, June, Vol 21, No 2.

2 Milton Friedman (1962), *Capitalism and Freedom*, University of Chicago Press, Chicago, p 8.

3 Friedman, *loc cit*.

events in China and other Asian countries are slowly demonstrating. Over the long term, democracy (political freedom) is necessary to guarantee economic freedom and prosperity, since authoritarian regimes are poor at providing security of property rights, especially at times of transition.

Fundamentally, there are only two ways to coordinate the economic activities of large societies. One is central direction involving the use of coercion – the technique of central planning and totalitarian regimes. The other is the voluntary cooperation of individuals – the technique of the market place.

A free private enterprise economy rests on voluntary cooperation. Willing buyers enter into transactions with willing sellers that both parties believe will make them better off. Cooperation is achieved without coercion. Absent fraud or monopoly, consumers, renters, investors and workers are protected from coerced bargains by competition among other parties wanting to deal with them.

Adam Smith postulated over two hundred years ago that, as if guided by an invisible hand, market competition and the pursuit of self-interest (profit) produce unintended benefits for the wider public. Smith also highlighted the importance of a high degree of individual liberty and economic freedom for prosperity:

> Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes and a tolerable administration of justice; all the rest being brought about by the natural course of things.[4]

Economic freedom is about freedom of action and exchange and security in person and in rightfully owned possessions. It includes the freedom of people to spend their money as they wish, and to choose their lifestyles, occupations and places of work. For both businesses and individuals it involves freedom in making decisions on investments, products and trading partners. Freedom of contract is a core aspect of economic freedom.

Economic freedom cannot exist without private property. Individuals are economically free if property that they have legally acquired is protected from invasions or intrusions by others, and if they are free to use, exchange or give away their property so long as their actions do not violate other people's similar rights.[5] If people are not free to sell the property they have in their own labour they are not free. Private property allows people to come together for mutually beneficial exchanges. The institution of private property is also critical for the existence of political and individual freedoms.

Since the fall of communism there has been little dispute that prosperity depends on the existence of private property. People look after what is theirs; they have confidence to invest in the expectation of future returns. With common ownership there are weak incentives to be productive and tendencies to waste and pollute. Recent history has shown that market economies not only out-perform centrally planned economies but are environmentally cleaner, safer and healthier as well.

The relationship between economic freedom and prosperity is not quantifiable in a straightforward way. In recent years, however, a number of researchers have

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4 Adam Smith, *The Wealth of Nations* [1776] 1973, University of Chicago Press, Chicago, p xl.

5 *The Economist*, 13 January 1996, p 19.

constructed measures of economic freedom across countries and through time and related them to measures of economic performance. The best known of these projects are those undertaken by the Fraser Institute in Canada and the Heritage Foundation in association with the *Wall Street Journal* in the United States.

The initial Fraser Institute study used 17 measures of freedom in four broad areas. As summarised by *The Economist*, these were:

- *Money and inflation* Does government protect money as a store of value and allow it to be used as a medium of exchange? This measure includes the volatility of inflation; monetary growth relative to the potential growth capacity of an economy; and citizens' rights to hold foreign-currency accounts at home and bank accounts abroad.
- *Government operations and regulation* Who decides what is produced and consumed? The measures of this include public spending as a share of gross domestic product (GDP); the size of the state-controlled sector; price controls; freedom to enter markets; and controls on borrowing and lending rates.
- *'Takings' and discriminatory taxation* Are you free to earn, and to keep your earnings? Measures of this include subsidies and transfer payments as a share of GDP; the level and impact of marginal tax rates; and whether there is conscription.
- *International exchange* Are you free to exchange goods and money with foreigners? Measures of this include taxes on international trade; any differences between an official exchange rate and a black-market one; the actual size of a country's trade relative to the size that might be expected; and restrictions on capital flows.[6]

The study rated 102 countries for five separate years over the period 1975–95 on each of these measures on a scale of 0–10, where zero means that a country is completely unfree and 10 means it is completely free. The results showed an increase in absolute measures in economic freedom for most countries, reflecting the worldwide moves towards economic stabilisation and liberalisation since the late 1970s. The expected relationship between the relative rankings of countries and their economic performance was borne out: in the words of *The Economist*:

> … the conclusion from this research could scarcely be more striking: the more economic freedom a country had in that period, the more economic growth it achieved and the richer its citizens became.[7]

Six countries that had persistently high rankings throughout the 1975–95 period (Hong Kong, Switzerland, Singapore, the United States, Canada and Germany) were all in the top 10 in terms of gross domestic product per head in 1993–95. By contrast, no country with a persistently low rating was able to achieve even a middling income.

Some specific cases are noteworthy. Ireland is a country that has moved rapidly up the rankings of economic freedom and has enjoyed commensurate improvements in economic performance. The East Asian countries, including Japan, also occupy relatively high positions, contrary to beliefs that their economies have been heavily state-directed. Japan is losing ground, however: in the Fraser Institute's survey it is in

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6 *The Economist*, *op cit*, p 20.

7 *The Economist*, *op cit*, p 19.

twentieth position for 1999, down from ninth in 1990. One factor in this fall is the growth in government spending in Japan, from below 20 percent of GDP in the late 1960s to around 46 percent today, according to the latest Organisation for Economic Cooperation and Development (OECD) figures.

Since the initial studies were carried out more work has been done to improve the data and methodologies. Clearly there is room for debate over the weight to be applied to the different measures of economic freedom. David Henderson has suggested that the measures may not be fully capturing important trends, such as increased intervention in some economies in labour markets, restrictive environmental policies and health and safety regulations.[8] A point emphasised by the researchers is that it takes time for improvements in economic freedom to be translated into better economic performance: individuals and companies have to believe that the changes will last before they alter their behaviour in productive ways.

Some people have questioned why New Zealand's economic performance hasn't been better, given the moves to free up the economy. On the Fraser Institute rankings, New Zealand was in eleventh place in 1990 and second in 1995, and was still in third position on the basis of 1999 data in the latest survey. Several comments are relevant.

First, prior to 1984 New Zealand was one of the most repressed economies in the OECD, and the legacy of the distortions, business practices and attitudes of that era was bound to affect its economic performance for many years. The transition to a freer economy was inevitably painful, as in the former Soviet Union and Eastern bloc countries. It was made more difficult by the 1987 sharemarket crash and by the failure of the 1980s Labour government to implement a fully coherent programme, with fiscal, labour market and welfare policies being key weaknesses.

However, as predicted by the economic freedom methodology, economic growth improved sharply in New Zealand after the second wave of reforms in 1990–91 produced a more consistent economic framework, and remained strong through the mid-1990s. Other indicators of economic performance also improved. Some of this improvement has been sustained: for the 1990s as a whole, average per capita incomes grew by 1.7 percent per annum in real terms, twice the 0.8 percent rate recorded over the last three decades on average. Nevertheless, there have been few further moves towards greater economic freedom in recent years, and with the changes in the opposite direction since the change of government in 1999, combined with ongoing liberalisation elsewhere, New Zealand's ranking is likely to fall in future years. Given the need for investor confidence that a general shift toward economic freedom will be maintained and enhanced, this stalling and reversal of policy is likely to have undermined growth. In addition, factors such as the Asian crisis and droughts have affected the economy's performance. Also, it is likely that New Zealand needs to have superior policies to those of other countries to offset its disadvantages of size and location if it is to match their economic achievements.

Economic research has not only established strong links between economic freedom and prosperity; it has also shown that freer economies tend to have more equal distributions of income.[9] More importantly, since a focus on poverty makes more sense than a preoccupation with inequality, studies have shown that growth is good

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8 David Henderson (1997), *Agenda*, Vol 4, No 2, p 216.

9 See Brian T Johnson, Kim R Holmes and Melanie Kirkpatrick, *1999 Index of Economic Freedom*, Heritage Foundation and *Wall Street Journal*, pp 12–15.

for the poor.[10] In addition, open and competitive markets punish prejudice and reduce discrimination – to a trader the colour of a person's money is more important than the colour of their skin.[11] Thus minorities stand to gain more from free markets than from political processes where majoritarian politics will always dominate.

Of course it cannot be too strongly stressed that economic freedom does not mean an absence of government. Markets can only operate within a framework of laws laid down and enforced by governments – we need governments as rule-makers and umpires to protect individual and commercial freedoms. Among other things, market liberals want governments to protect property rights, promote competition, provide a monetary framework, step in to fill gaps where the market can't work or fails, look after the interests of people unable to make decisions for themselves, and provide a social safety net, including underwriting access to services such as health and education. These are important functions: the consistent liberal is not an anarchist. Moreover, the role of the state can never be spelled out once and for all in terms of specific functions – new problems and new circumstances will always arise.

Far from reflecting an anti-government mentality, the liberal concern is that by trying to do too much the state has actually grown weak and is often unable to discharge effectively its core functions such as national defence, law enforcement, the provision of public amenities or protection of the environment. Only by doing less can the state do more, and in the process undo the damage it has done to self-reliance, enterprise and even the family by its clumsy interventions.

The widespread use of the market reduces the strain on the social fabric by minimising the number of issues on which political decisions are required. Political decisions are inherently divisive – as in Michael Cullen's 'We won, you lost, eat that!' – and tend to impose conformity and one-size-fits-all solutions. Milton Friedman has pointed out that the market is a form of proportional representation – each person can vote, as it were, for the icecream flavour of their choice; they don't have to accept what the majority wants. By contrast, Friedman notes that the use of the political form of proportional representation tends towards fragmentation and ineffectiveness and weakens the state's ability to perform its key functions.[12]

The best label for the economic viewpoint that I have been outlining is liberalism. Historically, it has encompassed ideas such as personal freedom and responsibility, representative government, reduction in the arbitrary power of the state, open markets and free international trade. In the United States the meaning of the term 'liberal' changed in the 1930s when it took on connotations of welfarism and state paternalism with the policies of the New Deal. The value of the term may have been damaged beyond repair in that country, but it has retained its integrity to a greater degree elsewhere. It should also be said that liberalism is not to be confused with conservatism – the liberal viewpoint is open to ongoing changes in social institutions, and in particular is opposed to conserving state-conferred privileges.

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10 See David Dollar and Aart Kraay (2000), 'Growth is good for the poor', Development Research Group, The World Bank.

11 A powerful case has been made by Alvin Rabushka for markets being the most potent agent for racial harmony and collective politics often being divisive and destructive (A Rabushka (1974), *A Theory of Racial Harmony*, University of South Carolina, Columbia, SC).

12 Friedman, *op cit*, p 23.

It follows that liberal doctrines have not been consistently associated with political parties of the left or right, either historically or in the modern era. In France and in the United States, liberal ideas were initially associated with the political left. Karl Marx was no purveyor of liberal ideas in general, but he favoured free trade and shared similar views to John Stuart Mill on the role of the state in education. Both thought that government financing of education need not imply government schools. As Marx put it:

> '*Elementary education by the state*' is altogether objectionable. Defining by general law the financial means of the elementary schools, the qualifications of the teachers, the branches of instruction, etc, and … supervising the fulfilment of these legal specifications by state inspectors, is a very different thing from appointing the state as the educator of the people! Government and church should rather be equally excluded from any influence on the school.[13]

In similar vein Mill wrote:

> A general State education is a mere contrivance for molding people to be exactly like one another … in proportion as it is efficient and successful, it establishes a despotism over the mind … An education established and controlled by the State should only exist, if it exists at all, as one among many competing experiments …[14]

Mill favoured "a law rendering education compulsory, combined with State aid to those unable to defray the expense".[15] Both Marx and Mill were supporters of what we would today call school choice – competition between government and private schools and equal funding for both. The Business Roundtable supports school choice and for some reason is sometimes called 'new right'. The left-wing teacher unions oppose school choice. Make sense of that if you can.

In the modern era, moves towards economic liberalism have been initiated from both sides of the conventional political divide. Governments with left-wing credentials in countries as different as China, Mexico, Australia, New Zealand, Sweden, Spain and Ireland have carried through liberalisation measures. In the United Kingdom and the United States there has been a broad continuity of policies between administrations such as those of prime ministers Margaret Thatcher and Tony Blair and presidents Reagan and Clinton. It is certainly not the case that parties of the 'right' are naturally more inclined to liberal ideas: Britain under Edward Heath, Spain under Franco and the former nationalist regime in South Africa all maintained tightly regulated economies. In France, not long ago, the prime minister of the then government of the right, Edmond Balladur, said in an interview: "What is the market? It is the law of

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13 Karl Marx, Critique *of the Gotha Programme*, written in 1875 though first published only in 1891. The text quoted here is from p 42 of an edition published in Moscow in 1947 by the Foreign Languages Publishing House. The italics are in the original – Marx was quoting from the text of the Programme.

14 John Stuart Mill, *On Liberty* [1859] 1956, Bobbs-Merrill Educational Publishing, Indianapolis, p 129.

15 Mill, *op cit*, p 130.

the jungle, the law of nature. And what is civilisation? It is the struggle against nature".[16]

What is the outlook for liberal economic ideas? Certainly it seems better than in 1889 when the Fabian Sidney Webb wrote:

> The steady increase of government regulation of private enterprise, the growth of municipal administration, and the rapid shifting of the burden of taxation directly to rent and interest mark in treble lines the statesman's unconscious abandonment of the old Individualism, and our irresistible glide into collectivist Socialism … No nation, having once nationalised or municipalised any industry, has ever retraced its steps or reversed its action. No failure of any experiment in such 'collectivisation' is anywhere recorded.[17]

Exactly 100 years later the major collectivist experiments of the twentieth century came to an end with the fall of the Berlin Wall, and those experiments do not look likely to be repeated in most parts of the world. Since the end of the 1970s, there has been a remarkable shift in OECD countries and many others in the direction of liberalisation. A relatively open international regime for trade and investment seems here to stay. Since around 1993, government spending has been falling as a share of national income in most OECD countries and many have lowered taxes and eased regulation. Privatisation continues around the world.

Yet, at the same time, as David Henderson has noted, public opinion in many countries remains hostile to markets and supportive of extensive government roles and powers of an anti-liberal nature.[18] Some governments have sought a 'third way' between socialism and the market economy. Support for protectionism, nationalism and collectivism is still strong. In New Zealand we have seen recent moves to greater state ownership and control in accident insurance, banking, electricity, airlines and rail passenger services, and the establishment of a state superannuation fund, as well as many moves to greater economic regulation. Internationally, there have been anti-globalisation protests on a large scale, and some have interpreted the terrorist attacks on the United States as a backlash against the liberal ideas that America stands for. As one writer put it, criticism of American values:

> … unites the Islamic terrorist, the anti-globalization street protesters, the resentful right, and the literary left. They hate the culture of markets and liberalism. They hate the Enlightenment and modernity. They hate reason, science, technology, individualism, pluralism, tolerance, progress and freedom. And to be more specific, they hate Wall Street, Hollywood, McDonald's, Starbucks, Microsoft, Ralph Lauren ads, and the casual joy of American freedom. These people share H L Mencken's definition of Puritanism: "The haunting fear that someone, somewhere, may be happy".[19]

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16 Quoted in David Henderson (1999), *The Changing* Fortunes *of Economic Liberalism: Yesterday, Today and Tomorrow*, Institute of Public Affairs and New Zealand Business Roundtable, Wellington, p 48. This study has been republished by the Institute of Economic Affairs, with a new preface by the author.

17 *The Economist*, 28 January 1989, p 55.

18 Henderson, *op cit*, p 81.

19 David Boaz, 'Attacks on American Values', Cato Institute, 1 October 2001.

None of us can know for sure how the conflicts of visions, clashes of ideas and the influence of apparently practical but mistaken 'do-it-yourself' economics will play out precisely over the period ahead. Nevertheless, economic research is continuing to demonstrate the clear links between economic freedom and prosperity, and governments are under pressure to achieve the improvements in standards of living that good policies and institutions make possible. I tend to share the optimistic view of Milton Friedman, probably the most influential economist of the last 50 years, about the prospects for economic liberalism. Friedman concluded his memoirs, written with his wife Rose in 1998, with the following reflections:

> Judged by practice, we have, despite some successes, mostly been on the losing side. Judged by ideas, we have been on the winning side. The public in the United States has increasingly recognised that government is not the universal cure for all ills, that governmental measures taken with good intentions and for good purposes often, if not typically, go astray and do harm instead of good. The growth of government has come to a halt, and seems on the verge of declining as a fraction of the economy. We are in the mainstream of thought, not as we were 50 years ago, members of the derided minority.
>
> So we close this book full of optimism for the future. Our children and grandchildren will live in a country that continues to advance rapidly in material and biological well-being, and that gives its citizens ever wider freedom to follow their own values and tastes, so long as they do not interfere with the ability of others to do the same.[20]

Let's hope that Friedman's optimism proves justified for New Zealand too.

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20 Milton and Rose D Friedman (1998), *Two Lucky People: Memoirs*, University of Chicago Press, Chicago, pp 588–89.

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