GROWING PAINS

NEW ZEALAND BUSINESS ROUNDTABLE
SEPTEMBER 1995

FOREWORD

This collection of speeches and articles is the eighth in a series produced by the New Zealand Business Roundtable. 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) and *The Next Decade of Change* (1994).

The material in this volume is organised in six sections: economic directions; fiscal policy and the public sector; regulation and commercial law (which includes a paper by David Trebeck, consultant to the NZBR, on agricultural marketing policy); education and the labour market; submissions; and miscellaneous speeches and articles.

A full list of NZBR publications is also included.

R L Kerr
EXECUTIVE DIRECTOR

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INSTITUTE OF DIRECTORS
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GROWING PAINS

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NEW ZEALAND BUSINESS ROUNDTABLE

AUCKLAND
18 JULY 1995

GROWING PAINS

It's hard not to feel good about the current business environment in New Zealand. Most of us in business today are, for the first time in our lives, part of a successful economy. By and large we have the freedom and the responsibility to run our businesses at international standards of excellence. We have only ourselves to blame if we don't succeed.

The country has been receiving some well-deserved accolades recently, and not just from the New York Yacht Club. Recently I came across a paper by David Henderson, the top economic official in the OECD for some years in the 1980s. Discussing the worldwide shift from interventionism to freer markets in the international system, Henderson described New Zealand as the clearest example of radical change and went on to say:

> Here a transformation has indeed taken place, a transformation in institutions, relationships, attitudes and perceptions, in the mode of operation of the economy and the role of government within it. The old way of economic life has largely vanished, nor can one see it as being restored in anything like its former shape.

The New Zealand success story has become highly topical abroad. I'm aware of top-level interest over the last year or so in the United States, Britain, Canada, Australia, Germany, Sweden and Norway - all countries with deep economic problems. No doubt there have been many more such contacts. I'm told that the New Zealand budget is now on the Internet and that the number of times it has been accessed this year exceeds the number of copies that were printed for sale.

The economic indicators continue to point in the right direction. By the end of this year, national income will be around 20 percent higher than it was at the bottom of the last recession in 1991. That's the equivalent of adding another Christchurch and Wellington to the economy. If you don't think Wellington produces anything useful, make that Christchurch, Hamilton, Dunedin and Palmerston North.

Over the three years 1994 to 1996, the latest OECD forecasts have employment in New Zealand growing by just under 10 percent in total compared to 3 percent in the OECD as a whole. Investment in the period is expected to grow by 44 percent in New Zealand compared with 17 percent in the OECD. This year OECD countries are running budget deficits averaging about 3.5 percent of GDP whereas New Zealand is running a budget surplus of the same size.

Clearly the economy has slowed down over the last few months, but it is still performing well. There are some indications that business and consumer confidence are on the rise again. Through 1996 growth should pick up as a result of falling interest rates, the introduction of very large tax cuts and the influence of recent strong business investment.

But it would be folly to assume New Zealand is on some primrose path and can now just amble along picking the flowers. We didn't get where we are today by accident, and we won't maintain our position by accident either. A theme of Margaret Thatcher's latest book is that it was the distaste of British governments for fundamental analysis in the 1960s and '70s that left Britain at the mercy of events. We have to go on asking the hard questions.

Life in the open economy is tough. It's especially tough for producers, because the economy is no longer designed for them. Most of it is now designed for consumers. I saw a survey recently which found that 96 percent of New Zealanders think that the most important requirement for any business is to be committed to providing quality goods and services to their customers. It's good to know that 96 percent have got it right. Our customers internationally have always had choice, and now our domestic customers have too. We must be excellent in everything we do or we won't have customers.

When firms are under pressure, there are always some who want the government to help them out. Protectionism just takes new forms. Recently there have been complaints from some exporters about the exchange rate, particularly those selling into Australia. The reality is that most of the problem arises from the collapse of the Australian dollar, which in turn is due to the mess Australia has been making of running its economy. There is nothing New Zealand can do about the problem other than to reduce our exposure to Australia, and to do what we can to help those Australians who know their economy will have to be reformed along New Zealand lines. From Lion Nathan's perspective, the sooner that happens the better.

Even though some of us are hurting at the moment, we had better not forget that competitiveness has nothing to do with a weak currency. We had one of those for most of my working life, and it did nothing for competitiveness on a sustainable basis. Like the guns of Singapore, those who were preoccupied with the level of the currency were facing in the wrong direction. The real culprits were things like high inflation, the imbalance between monetary and fiscal policy, the rigid labour market, import protection, high domestic cost structures resulting from barriers to competition, inefficient state enterprises and badly managed firms.

The situation is no different today. Monetary policy is not the issue. All the indications are that the Reserve Bank has done a good job of keeping inflation in check, and, if anything, could have leaned against inflationary pressures a bit harder and sooner. There is no evidence that it is over-doing things: no commentators see the path of underlying inflation dipping below the 0-2 percent range. To the extent that we should be worrying about competitiveness, we should be looking in other directions.

If New Zealand maintains an inflation rate below the average of our trading partners and an above-average rate of productivity growth, our exchange rate is likely to appreciate over time. Over the long run, an appreciating exchange rate, like higher real wages and increasing real per capita incomes, is a sign of good economic health. Through cheaper imports and higher purchasing power overseas, it spreads the gains from a better economic performance.

At the same time, a rising currency creates growing pains for any economy. For most of the last thirty years, Japanese manufacturing industry has had to cope with a rising yen - and often with sharp adjustments in its value, not just a smooth upward trend. Because Japanese governments typically refused to bail out unprofitable firms, they had to restructure - not just once but time and again - or die. Firms which believed, rightly, that they were at the leading edge of international excellence had to push themselves to new levels. Others failed, and resources were put to more profitable uses. New Zealand businesses are also having to learn that restructuring and innovation is an endless process.

One part of the New Zealand economy where the growing pains of a successful economy are particularly acute is agriculture, though few in the sector seem to realise what is happening. Already over the last fifteen years, agricultural production as a percentage of GDP has shrunk dramatically. From being over 10 percent of the economy in the late 1970s, it will fall to 4.8 percent next year according to the latest MAF forecasts. Employment in agriculture is not growing, and confidence and investment intentions are very weak. Over the next three years, agricultural sector income is expected to be around 25 percent below the level of the last three years.

At the same time, the latest government budget projects non-commodity manufacturing exports to grow by 70 percent over the next three years, and tourism receipts to grow by 55 percent over that period. By 1997/98, non-commodity manufacturing and tourism exports are together expected to earn about the same amount as all primary exports combined.

What is going on here? Why is agriculture stagnating at a time when the world economy is strong and barriers to world trade in agriculture are coming down? Part of the answer is that productivity and innovation in the sector are not keeping pace with developments in the rest of the economy. The exchange rate and other asset prices are being driven by the leading sectors, just as the mining industry and North Sea oil drove the exchange rate in Australia and the United Kingdom in earlier periods. Inevitably, lagging sectors are squeezed.

Given the enormous gains from the deregulation and corporatisation of telecommunications, electricity, airlines, ports and other industries, it doesn't take a genius to figure out some of the problems. While on-farm production is deregulated and unsubsidised, the processing and marketing structures beyond the farm gate are still part of old New Zealand. A recent Calvin and Hobbes cartoon summed it up very simply. Calvin was writing the following letter:

> Dear Santa. Attached is my Christmas list for this year. Last year I did not receive several items from my list. For your convenience I have grouped those items together on page 12. Please check them carefully, and include them with the rest of my loot this year.

Then Calvin turns to his toy tiger Hobbes and says:

> That's the problem with this guy Santa. He's gotten sloppy without any competition.

The single seller monopolies and the controls over meat and wool are blocking new market linkages, new investment, innovation, and branding and product differentiation strategies which could add enormous value to New Zealand raw materials. The fact that exports by Heinz-Wattie have doubled from $100 million to $200 million since Heinz became involved with the company in 1992 gives some idea of the opportunities that are being forgone.

In the producer board debate, there is great resistance to engaging in fundamental analysis of the issues. The boards' response is too often to resort to smokescreens and rhetoric.

Last time I spoke on the subject, the response of the chairman of the Dairy Board was that New Zealand's exports of beer were quite small. That is about as relevant as observing that New Zealand doesn't export much fresh milk. A Dairy Board study came up with the patently obvious finding that, in competitive markets, cooperatives and corporates can both succeed - a finding that has nothing to do with the performance of cooperatives subject to statutory controls or the distorted price signals they send to farmers. To be fair, the Dairy Board has recently commissioned a good quality EVA study, but it has no policy implications and raises a range of questions that need to be pursued. This year the Apple and Pear Marketing Board commissioned an academic to review its performance by asking its customers what they thought of the board. What would you expect the customers of a monopoly seller to say? Yet somehow these exercises keep the boards' constituents happy.

I am therefore pessimistic about the future of these industries. None of them is getting to grips adequately with the relevant issues. Just as the former trade union leaders were more interested in their jobs than the interests of workers, the boards seem more concerned with self-preservation than with farmers' best interests. The fact that the meat industry is having another debate about single selling arrangements after the sheepmeat disaster of the 1980s is unreal. The problems with the dairy industry are far less visible but may be even deeper. While we are likely to see piecemeal moves towards deregulation and corporatisation, I suspect they will be too slow. The most likely scenario is one of continuing low farm incomes, more plant closures, out-performance by foreign competitors, less funding for research and other agricultural services, and a continued shrinkage of agriculture as a share of GDP. While resources will shift to forestry and other alternative uses, this is a sad outlook for industries which should intrinsically be among New Zealand's most competitive.

Agriculture and other internationally competing industries would also be helped if New Zealand were pressing on with economic reforms which would strengthen our competitive position. Federated Farmers' statements over the past year have often referred to farmers being 'grumpy', but their statement on the recent budget suggested they were quite happy with it. This was despite the fact that the government had committed around 1 percent of GDP of new spending in the past year, an amount that has clearly put an additional squeeze on the private sector. Moreover, apart from the projected tax cuts, there were no signs of major new initiatives to raise the economy's performance above its present level.

In the absence of such initiatives, I suspect New Zealand will experience additional growing pains. They are not likely to occur in markets which are deregulated and flexible and where the private sector will quickly respond to new demands. Today we have telecommunications services coming out our ears instead of long delays for connections. Companies are falling over themselves to invest here because of the attractiveness of the deregulated telecommunications market. The new employment and training market is far less prone to skill shortages. Where we are likely to run into bottlenecks is in areas still subject to slow and cumbersome political decision making such as roading, electricity, the fire service, water, health and education.

Water is a good example of a large industry where New Zealand is falling well behind the rest of the world. There are a range of options for change, including metering, better contractual arrangements with customers, improved infrastructural management, regulatory reform, franchising, corporatisation and privatisation. Few of them are being examined vigorously by those responsible, and politicians seem totally allergic to the mere mention of privatisation. MP Nick Smith, for example, has described those who have raised the option of privatisation as "right wing zealots" and "nuts", and Wellington Regional Council chairman Stuart Macaskill has termed the ideas "extremist" and "nonsense".

Privatisation is by no means the only issue in water, but these politicians appear to have overlooked the fact that even in New Zealand there are many forms of private water supply - Oamaru's water, for example, is wholly supplied under private contract. Like many of its privatisation initiatives, the privatisation of water in the United Kingdom was not handled well, but it has improved services and cut charges relative to what would have happened - by up to 13 percent in the case of one water company. In Australia, Adelaide is planning to contract out its water supplies to the private sector, and Victoria is engaged in large scale structural reforms and corporatisation. In Chile, which, for the benefit of Mr Smith, has a centre left government, the aim is to increase as much as possible the participation of the private sector in infrastructure, and the government recently announced plans to privatise up to 65 percent of water supplies and the sewage system. Many other countries are engaged in similar reforms. A World Bank water specialist recently commented that if New Zealand doesn't get a move on, it will find itself lagging behind Bangladesh.

If the business community, and indeed the community at large, want to see New Zealand continue to move forward, they will have to stand up to politicians who prefer name-calling to serious debate about issues. The supporters of practically all the major reforms since 1984 were branded with similar names at one time or another. The economic record since then shows how foolish many of their opponents were. Gordon McLauchlan's book, *The Big Con*, for example, now looks more like an autobiography.

Warwick Roger has often remarked that the media in New Zealand were slow to understand and explain the necessity for change. Today they seem divided between those like *The Herald* and the two weekly business papers which are advocates of ongoing reforms, and those like *The Evening Post* which maintains the habit of knee-jerk reactions and *The Dominion* which appears to be drifting backwards. In the last month or so, *The Dominion* has come out against producer board reforms, in favour of restoring tax breaks for superannuation, and against privatisation of postal services, despite NZ Post's obvious belief that it could do an even better job if it wasn't state-owned. The *Sunday Star-Times* and the *Listener* are notorious for not printing letters which respond to misrepresentations in their columns. But the response to such things should not be to get angry; it should be to expose the weaknesses of arguments through research and evidence. Deregulation of the editorial columns so that their authors were named and accountable for their views might help!

May I close by saying I am encouraged to learn of the strategic review which the Institute of Directors has been undertaking in recent months with the aim of upgrading itself as a business organisation. To be credible, it must become more than a directors' union, and be prepared to address issues from a national interest perspective. The commitment to research and intellectual integrity is especially welcome. I was glad to hear that the Institute is reviewing its position on takeover regulation on this basis, as it has been the only business organisation favouring more restrictions. This will be a litmus test of the new approach.

It has also been pleasing that the Institute is taking an interest in a wider range of issues, such as foreign investment and the Privy Council. The welfare of shareholders and the community will be far more dependent on, say, the fate of the Reserve Bank and Employment Contracts Acts than on things like the types of liability directors can insure themselves against.

The fundamental interest we all share is in further improvements to the New Zealand business environment, as this is the only route to more jobs and higher incomes for all. The remarkable change in New Zealand is that few, if any, business organisations are now promoting the immediate self interest of their members. One reason for my personal admiration for Sir Ron Trotter is that he was part of the fortress New Zealand business environment, but was one of the first to realise it had to change - for the good of business and the country. Others progressively followed. Who would have thought ten years ago that manufacturers' organisations would abandon lobbying for protection and instead put their weight behind the arguments for a more open and competitive economy? Who wants to turn the clock back? No industry was knocked around more than the liquor industry by deregulation - it cost Lion Nathan about $200 million in shareholder value in hotels alone. Would we wish it had never happened? Not for one minute.

The cohesion and the credibility of New Zealand business organisations, now that they have taken the wider view, contrasts with the disarray in Australia. Few executives in Australia are prepared to speak out about the government's economic mismanagement. People running businesses that affect the welfare of many stakeholders are abrogating their responsibilities if they choose to stay silent because of fear of political reaction. They demean the debate and themselves if they confine themselves to applause. MP Max Bradford recently criticised the business community for not doing enough to challenge political parties which are doing their best to undermine investment confidence with damaging and backward-looking policies. It was a fair point that we should all heed.

There is no reason why New Zealand cannot continue to move ahead. There has been a sea change around the world. Speaking of his own country, Britain, David Henderson said in the paper I quoted earlier:

> I believe that a Labour government, if elected now in Britain, would do little if anything to renationalise industries, to re-regulate financial markets, or to restore the former powers and immunities of trade unions. Indeed, such a government might well continue along the path of reform, possibly in more innovative ways that its immediate predecessor of the post-Thatcher years.

Equally, however, change will not occur, especially in the MMP era, if major sections of the community do not put their minds to making it happen. Governments, or more particularly the main governing party, will be less important; the institutions that help shape public opinion will become more so. One of the possible upsides to MMP is that it may put a premium on good research and sound arguments. Special interest groups such as unions or farmers will no longer be able to rely on their ability to muscle 'their' party to deliver them statutory favours. We have seen groups like the church marginalised in the economic debate, not because they had the wrong motivations but because they had not done their homework and they came up with the wrong answers. Organisations with a capacity for research of high quality and integrity are likely to have the advantage in the new environment.

We are a much more economically literate country than we were a decade ago, with a greater willingness to engage in fundamental analysis rather than be satisfied with the politics of the conventional wisdom. There is no place on our boards today for directors who don't do their homework and don't get to grips with the wider social environment in which their companies operate. We should not allow our organisations to say things on our behalf if they haven't followed the same disciplines. To achieve excellence in international competition today, the culture of fundamental analysis in both corporate and public affairs must be preserved and reinforced. That is a challenge for all of us, and our organisations.

AUSTRALIAN STOCK EXCHANGE ANNUAL DINNER

HIGH ACHIEVERS OR TIMID GRADUALISTS? THE AUSTRALASIAN DILEMMA

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

MELBOURNE
26 JUNE 1995

HIGH ACHIEVERS OR TIMID GRADUALISTS?

It is a very great honour to be invited to give this address. It's also a pleasure to be in the company of many good personal friends and good friends of New Zealand. I want to pay a special tribute to Maurice Newman whose contributions as chairman of the Centre for Independent Studies for many years have been of great value to New Zealand. As chairman of the Australian Stock Exchange he has already played a very constructive role in strengthening relationships between our two stock exchanges and investment markets.

I have been asked to offer a New Zealand perspective on what has happened in both our countries over the last ten years or so, and to reflect upon what might happen in the foreseeable future.

The first, obvious, but nonetheless important starting point for any Kiwi speaking in Australia is to refer to Sir Henry Parkes' great metaphor at the federation conference here in Melbourne in February 1890, when he spoke of "the crimson thread of kinship." New Zealand took part in that conference but after 1890 New Zealand interest in joining in a federal structure of nationhood waned. Geoffrey Blainey suggests that one of the reasons for New Zealand disinterest was that in the 1890s New Zealand per capita incomes were higher than Australian incomes, particularly Victorian incomes, and that New Zealanders feared that their taxes would be used to subsidise the other colonies. Whatever the reason, the only legacy of those discussions today is Section 6 of the Australian constitution which guarantees a place for New Zealand in the Australian federation if New Zealand ever asks for one.

Many Australians thought that outcome was becoming imminent, not out of choice but of necessity, as they watched New Zealand governments embark on a seemingly unending rake's progress through the 1970s and early 1980s. From being one of the world's high income countries at the turn of the century, a position it maintained until the 1950s, New Zealand was going steadily downhill. By the early 1980s, we were no longer in the top 20, we had accumulated a mountain of debt, and the fall was becoming more precipitate.

The twentieth century history of both our countries owes much to the influence of socialism, the dominant political ideology of the century. Socialist ideas gained currency in the Antipodes before anywhere else in the English-speaking world. In New Zealand, before the Great War of 1914-18, "socialism without doctrine" became the watchword, and in Australia "state socialism" was explicitly implemented by conservative governments at the State as well as the Federal level.

What we might call "pragmatic socialism" led governments in both countries to become the owners (often monopoly owners) and operators of railroads, telephone systems, postal services, electricity supply networks, ports and airports, forests and forestry industries, water supply and sewerage systems, primary and then secondary schools, hospitals, abattoirs, gambling facilities, radio and television networks, airlines, shipping lines, insurance companies and banks. (This is not a complete list but it illustrates the point.)

Collectivist ideas permeated many other Australasian economic institutions. They were clearly manifest in our labour market regulations, in the erection of tariff walls and in the statutory marketing arrangements for primary products. The boundaries between the government and the private sector became blurred at an early stage. A business culture emerged which saw state intervention not as a threat but as a potential benefit for business. The president of the Associated Chambers of Commerce in New Zealand told his members in November 1934 that businessmen "should to some extent accept the tendency towards State control ... and should themselves participate in it." The blossoming of import controls, tariffs and subsidies over the following thirty years indicates they were not slow to follow this kind of advice.

In New Zealand such ideas achieved an unchallenged dominance, politically and intellectually. By the 1960s we were into various forms of indicative planning. In Australia, socialism was to a greater extent held at bay for most of the post-war period by the Menzies governments. Only under Whitlam was there a brief fireworks display of socialist confidence. With the worldwide collapse of socialism in the 1980s and early 1990s, that confidence has largely evaporated. Yet in both our countries there is still resistance to ideas such as privatisation, despite the overwhelming practical evidence of the superiority of private over state enterprise. This can be traced in part to atavistic attachments to the credo of "public ownership of the means of production, distribution and exchange."

The result of what the Fabian socialist William Pember Reeves called the "state experiment" in New Zealand was ultimately much more complete economic stagnation than in Australia, culminating in the economic crisis of 1984. David Lange, the incoming prime minister in the election of that year, likened New Zealand to a Polish shipyard.

Of course, it was not as if New Zealand's predicament only became apparent when we found ourselves peering over the cliff a decade or so ago. In the early 1960s, official reports were already calling attention to the fact that New Zealand had the poorest productivity growth among the industrial countries. Robert Muldoon was elected prime minister in 1975 on the basis of his reputation as a finance minister capable of putting things right. The problem is that putting right things like high inflation and budget deficits always involves up-front costs, and Muldoon repeatedly backed down when the going got tough. His three wasted terms were characterised by tinkering, stop-go policies, increasing state ownership of industry, a steady slide into higher debt and bigger economic distortions.

A point worth emphasising, however, is that Muldoon did not deliberately set about to sabotage the economy. In many ways, as with the CER agreement, he was trying to do the right thing. But he was reacting too slowly in the face of growing problems. His approach was described as "timid gradualism." New Zealand kept losing ground relative to countries that were adjusting faster, and the problems got worse. If there is one lesson New Zealanders should retain from the Muldoon era, it is the perils of timid gradualism.

By the early 1980s, some Australian government officials were beginning to wonder whether Australia would end up having to bail New Zealand out of bankruptcy. That assessment is hard to quarrel with. Subsequent Australian interpretations of New Zealand events have been rather more variable. New Zealand does not loom large on Australian radar screens. In Paul Kelly's nearly 700-page book on Australian politics in the 1980s, it is mentioned twice. Some commentators like Alan Wood, Paddy McGuinness and John Stone have called the shots on New Zealand very accurately. Others have been well off target.

One line of commentary through the 1980s interpreted New Zealand as doing much the same things as Australia, but faster - a hare and a tortoise comparison. Another saw it as a "monetarist experiment." Critics pointed to the contrast between employment losses in New Zealand and employment gains in Australia, and to the long recession in New Zealand from 1988 to 1991. In the eyes of some commentators, the goods and services tax seemed to be the linchpin of our reforms. The labour reforms of 1991 were portrayed by the ABC as a descent into barbarism. The reaction of the *Australian Financial Review* to the 1993 general election and referendum results was "Kiwi Voters Drop their Bundle." Its reaction to the recent budget was "Kiwi Magic Leaves us Spellbound."

Recently your federal Treasurer called our restructuring policies "crude" and "brutal." No one seemed to get very upset. From our experience in watching Dame Edna slag off her Kiwi offsider, we knew it was said in a caring and sharing sort of way.

There's an element of half-truth in some of these observations, but the overall picture is somewhat out of focus. My own snapshot would be along the following lines:

- New Zealand started its economic reforms in a far worse position than Australia;
- some features such as financial market liberalisation, currency deregulation and tariff reform were common to the two countries, but New Zealand's programme was more principled and hence more comprehensive;
- New Zealand emphasised the medium-term fundamentals of macro stability and micro flexibility, whereas there has been a stronger emphasis on Keynesian-style demand management and a collectivist incomes policy framework in Australia;
- the necessary deep restructuring naturally meant that New Zealand initially lost ground relative to Australia, although the economy continued to grow in the 1984-88 period when confidence in the programme was high;
- the New Zealand Labour government's strategy became progressively less coherent as labour and welfare reforms were left in the 'too hard' basket and government spending continued to grow. Coupled with a tight monetary policy, this put unwarranted pressure on the real exchange rate and the internationally exposed sector of the economy;
- the 1987 sharemarket crash and the disintegration of the Lange government in 1988 led to a collapse of confidence, a deterioration in the fiscal position, battered company balance sheets, recession and higher unemployment;
- a second wave of reforms was initiated by the National government which came to office in late 1990. The key measures were the freeing up of the labour market, tighter fiscal discipline and some welfare reforms; and
- the more complete and consistent policy framework took pressure off financial markets and the currency, and improved our international competitiveness. This generated an export-led recovery which is now into its fourth year, a far longer and stronger period of expansion than any upturn in the last thirty years.

Inevitably the reforms came at some expense, but most of the pain was due not to the speed or depth of the restructuring but to the legacies of the earlier policy failures. There were already economic casualties before 1984 and there would have been many more if New Zealand had continued with timid gradualism. Looking back, a clear lesson from New Zealand's experience is what not to do: attempt an uneven pace and spread of reform. Eastern European experience has confirmed that economies which go for fast, radical and comprehensive reform achieve the most successful transition, the Czech Republic being the outstanding case.

Mr Willis would therefore have had a point if he was criticising New Zealand's unduly protracted transition, in particular the "teabreak" that David Lange called on the reforms in 1988. He would also have been correct in speaking about an unnecessarily brutal programme if he was thinking about the Labour government's failure to free up the labour market. This should have happened early in the programme and, if it had, many tens of thousands of workers would not have ended up on the unemployment register. But I am not sure that these are the kind of criticisms the Treasurer had in mind. (I did notice, however, that Bob Gottliebsen commented in a recent Business Review Weekly editorial that "in Australia we are showing our continued callous disregard of the unemployed by going the other way and talking about increasing minimum wages.")

I should immediately add that many of the criticisms in New Zealand of the reforms were at least as wide of the mark as those offshore. We were told that they were a mad experiment, despite being orthodox economics and in line with what many other countries were undertaking. We were told that eliminating inflation was inconsistent with growth, despite all the evidence that inflation is harmful to the efficient operation of the economy and investor confidence. A group of academics told us that the fiscal correction in 1991 would worsen the recession, whereas it marked the turning point of the recovery. Then the recovery was going to be a "jobless" one, whereas it has been churning out jobs at a furious pace.

Lately the complaint has been that the benefits of recovery have not been fairly spread, with low income groups in particular missing out. This too is almost certainly wrong. A recent EPAC study of income distribution in Australia reports evidence in the 1990s of real incomes from employment growing across the entire income distribution, in contrast to real income falls in the 1980s. I suspect the same thing is happening in New Zealand. The freer markets for labour have spread employment opportunities around in a much more socially just way than collective systems, which benefit those in jobs with high wage increases but exclude outsiders from work. Long-term unemployment, Maori unemployment and youth unemployment have all fallen sharply.

Despite the massive restructuring, the New Zealand economy recorded average annual real growth in the ten years 1984-94 of 1.6 percent, a slight increase on the 1.4 percent rate in 1974-84 - a period that some New Zealanders still regard as the "good old days." More importantly, recent performance and the current outlook are exceptionally good:

- growth has averaged over 5 percent in each of the last two years, and the budget forecasts suggest that, over the six years to March 1998, the economy will grow by an average of 4.2 percent;

- inflation has averaged 1.6 percent over the past 4 years;

- employment has grown by nearly 10 percent to record levels since the labour market reforms, and overall unemployment has come down from nearly 11 percent to 6.6 percent of the labour force;

- the current account deficit has been stable at around 2 percent of GDP despite high investment, and is expected to fall. National savings are rising sharply and export growth is matching the growth of imports;

- the budget surplus is expected to be 3.6 percent of GDP this year and to rise to 7.7 percent of GDP in 1997/98 in the absence of tax cuts; and

- net public debt is expected to be 34 percent of GDP in 1995/96, down from 51 percent in 1991/92, and is continuing to fall fast.

At long last New Zealand is starting to make up ground on Australia. The New Zealand dollar has appreciated some 40 percent against the Australian dollar since the mid-1980s. Our long-term bond rates have been 1-2 percentage points below yours. New Zealand has moved rapidly ahead of Australia in the rankings in the World Competitiveness Report. We are becoming a much better market for your exports, which grew by 40 percent over the last two years, putting New Zealand only just behind the United States as Australia's fourth largest export market. We are keen to attract a similar increase in investment by your major institutions.

There are still some in New Zealand who look at the present situation as just a passing spell of sunny economic weather, even though it may be lasting more than 5 minutes. They don't link the new economy with the hard work under the Roger Douglas and Ruth Richardson reforms. The reality is that the economy is now operating in a fundamentally different framework. Key pillars of this framework are:

- the progress towards a fully open, competitive economy. New Zealand tariffs are scheduled to be slightly lower than Australia's by 2000 and to go to zero thereafter;

- the Reserve Bank Act, which commits the central bank to the single target of price stability;

- the Fiscal Responsibility Act, which lays down criteria for sound fiscal management and requires the government to nominate its goals and report progress towards them in a transparent way. The Crown's accounts are also now prepared like any other business on an accruals and GAAP basis, with clear statements of public assets and liabilities;

- the Employment Contracts Act, which has moved the legal-institutional framework of the labour market on to a contracting basis, similar to general contract law. The basis of contracting is now between the firm and the employee. Collective bargaining is permitted and facilitated but bargaining agents like unions and employer groups are no longer given statutory protection. Strikes are not permitted while a contract is in force, only after it has expired.

In addition, most product markets have been deregulated; government commercial activities have been corporatised and many of them privatised; a broad-based, low rate tax strategy has been implemented (including the GST); and there have been significant changes to education, health, housing and superannuation policies. All these moves have strengthened the economy - there is nothing random about the sunny weather and no unexplained economic miracle.

Despite all this, I believe both New Zealand and Australia remain well off the pace in achieving a set of economic and social policies which would maximise our opportunities and living standards. Even by comparison with Australia, New Zealand still has a lot to be modest about. You were not foolish enough to adopt our state monopoly accident compensation scheme; you have made more progress than we have in dismantling statutory agricultural marketing arrangements; you are ahead of us on restructuring and privatisation in electricity and water; your welfare system is more targeted and better administered than ours; and on the criterion of how well the education system meets the needs of a competitive economy, Australia is in 9th place in the IMD survey whereas New Zealand is in 17th place, one above India.

But neither country is the relevant benchmark for the other. The relevant benchmarks are the high productivity, high income, high employment economies, particularly those in East Asia which, unlike us, have never had to throw off collectivist legacies and are continuing to surge ahead.

The success of the East Asian countries is primarily due to the same set of fundamental, market-oriented policies that New Zealand and Australia have been endeavouring to implement, but in many respects the quality of our policies still doesn't measure up to theirs. They have pursued outward-looking policies for longer than we have, and Hong Kong and Singapore have been free trade economies for many years. Their levels of government spending, taxation and debt are well below ours. To all intents and purposes they are fully employed economies, due to their more flexible labour markets. State-owned enterprises account for a much lower proportion of economic activity. Asian education is noted for its high quality, especially in vocationally and technologically sophisticated disciplines. Their welfare systems work whereas ours have failed us, and they constitute a big competitive handicap. It is little wonder that even at the peak of a cycle our economies only match Asian growth rates in a slow year.

The benefits in today's global economy of an enterprise-friendly fiscal and regulatory environment of the kind the East Asians have created were vividly demonstrated by the Queensland government's recent decision to halve stamp duties. The New South Wales and Victorian governments were quickly forced to follow suit, although hardly with good grace. Some press reaction was decidedly hostile. I was amused at a commentary by a lead writer of the *Canberra Times* which described Queensland's action as: "another poisonous apple in the fools' paradise of competitive federalism ..." and went on to say:

> Competitive federalism ... is a flawed view. Sometimes the best conditions for business result in poor living standards. ... Low taxes are helpful up to a point, but after a time they result in poorer services and poorer infrastructure to the very businesses you are trying to attract."

I suppose this type of nonsense could only have been written from Canberra - although it reminds me of the fear-mongering and dire predictions by many media organisations in New Zealand during almost every reform initiative of the past decade. Of course, competitive federalism should take the form of creating a generally attractive location, not bribing specific firms with tax breaks or subsidies. I also saw a complaint by an Australian union secretary who said the move would unduly constrain Queensland's already low level of social spending. The fact that it created jobs in Queensland seemed to be irrelevant. Attitudes like these indicate that some members of what former Finance Minister Peter Walsh would call the chattering classes still have a vast amount to learn about the realities of global competition. Fortunately, they do not seem to be dissuading the thousand or so Australians who each week are voting with their feet and moving to Queensland, apparently unconcerned by Queensland's inadequate social spending.

For my part, I applaud the Australian Stock Exchange's campaign on stamp duties. New Zealand totally eliminated stamp duties on share transactions seven years ago. Both our countries must stop piling on the tax burdens and regulations that are stifling corporate governance and making our capital markets less efficient. I wish the ASX could help its New Zealand counterpart and others opposing ill-considered moves in New Zealand to impose new regulations on takeovers, regrettably along Australian lines. In the panic that followed the 1987 sharemarket crash, our regulators said such regulations were necessary to restore foreign investor confidence in our equity markets. Though nothing was done, foreign investment has flooded in, to the point that other groups are now complaining about the extent of offshore holding of New Zealand equities. Yet still our regulators and minister of justice are persisting with proposals that have no justification on either efficiency or equity grounds. Even more bizarre, the New Zealand Business Roundtable, an organisation of chief executives who might be expected to lobby for regulations on takeovers, is accused of being a vested interest for opposing them.

It's easy for New Zealanders to feel flattered when leading Australian business people like Don Mercer of the ANZ comment that:

> Most of us in business in Australia look with absolute envy at what New Zealand has achieved.

Some New Zealand journalists, too, have taken to writing things about Australia like:

> With its growth rate still lagging behind this country's, unemployment bouncing back to 8.5 percent, a deficit the size of several woolly mammoths, a labour market in rigor mortis, and its currency rapidly falling close to parity with the Kiwi dollar, Australians are looking in a somewhat startled fashion at New Zealand's performance.

But there's no case for New Zealand indulging in self-satisfaction. Our economy is very vulnerable to policy and political risk. There is still a risk premium in our interest rates of around 1 - 1.5 percent, and we are far away from regaining the triple A credit rating we enjoyed until 1983. The government has a target of 3.5 - 5 percent annual growth to the year 2010, but without further significant reforms I very much doubt that it will be achieved.

The fact that Australia is struggling with the challenges of reform is also bad news for New Zealand. The airline fiasco has given a whole new meaning to the term 'microeconomic reform'. The use of taxpayers' money to fix industrial problems, as in the shipping industry, or budgets with company tax increases, random new sales taxes and creative accounting, take us back to the Muldoonist chamber of horrors. By the time Australia gets around to completing vital tasks like labour market reform and telecommunications deregulation and privatisation it will be lagging at least ten years behind New Zealand. An Australia that is performing so far below its vast potential does nothing for us. We are sorely missing a strong stimulus from Australia to keep up the momentum of our own reforms.

The sorry story of the opportunities we are missing was summed up recently by one of New Zealand's more hard-headed economic commentators, Gareth Morgan, in the following terms:

> All around New Zealand is strewn evidence of half-completed economic reforms, the net impact of which is invariably significant costs to economic efficiency, and a lower standard of living for those affected. The policy paralysis which has steadily descended since 1991 may well be seen as either a consequence of the democratic process of transition from FPP to MMP, or as just the inevitable outcome of a conservative political regime which is uncomfortable with change. Whatever, its economic cost is unambiguous.

We seem to have forgotten the warning about 'reform fatigue' that Lee Kuan Yew delivered in Australia last year. He pointed out that more reform was unavoidable, or the ordeal already endured might be wasted. The same lessons are coming from other countries. In Argentina, the re-elected government of Carlos Menem is pressing on with deregulation, privatisation and labour market reform, and its economy is likely to exceed Australia's in size in the near future. A comment by an Indian businessman in the *Australian Financial Review* last year summed up a dilemma which is easy for a New Zealander to relate to:

> It's a question of whether [India's] economy will grow at 6 percent a year if there are no further reforms, or 10 percent a year if we really move ahead with reforms. ... Instead of blowing its trumpet, the government is being apologetic. They've not done a good job of taking the people into their confidence, of telling them what reform is doing for the country. Some politicians still seem to think that good, strong, economic policies are somehow immoral.

The irony is that with sustained growth and falling unemployment, the challenges to adjust that lie ahead would be far less formidable than those of the last ten years. From next year, New Zealand can look forward to large tax reductions over several years, provided government spending is tightly controlled. In any case much of the talk of 'pain' is misplaced - where's the pain in governments spending less of taxpayers' money?

Nevertheless, those who have a vision of what both our countries might become will have to continue to work hard to overcome the impoverishing legacy of our collectivist past. In significant sections of the community and some political parties there is still a hatred of the profit motive, a wariness of commercial competition, class anger, an instinctive belief that business is best organised by the state, and an urge to 'correct' markets by taking and redistributing money. Every day on the airwaves, talkback hosts on six-figure salaries instruct their audiences about what they call the savage inequalities of capitalism.

Far more important than who the next government will be in Australia, or what the new electoral system will mean in New Zealand, are the vision and ideas that will hold sway. Will the electorate and our political parties jettison outdated ideological baggage as the social democrats did in post-war Germany and the British Labour Party appears to be doing today?

The answer to that question will in part depend on the role the business sector decides to play in both our countries. Hugh Morgan in a speech a few years ago pointed out that:

> Corporations are important as social institutions as well as economic agents. If the corporation can articulate and uphold its legitimacy, it can provide ... a shield against attacks on our traditional liberties.

Marx knew that to achieve his goals the business classes had to be destroyed. Newt Gingrich recently made the point that "American businesses can't win in the marketplace for products and services if they concede defeat in the war of ideas." Too often in the past, people in business have just gone along with policies that they knew were bad for the economy and bad for their firms in the long run. They must do more to explain the merits of competition and the enterprise system.

Through all of the reform debate over the past decade, the New Zealand Business Roundtable has scrupulously maintained a long-term, national interest focus, and backed its policy prescriptions with detailed, rigorous research. For this, we earned the hostility of elements of the media, trade unions and other commentators. Sometimes we were tempted to offer them Adlai Stevensons's bargain: If they will stop telling falsehoods about us, we'll stop telling the truth about them. But our response was merely to plough on and keep focused on the ball and not the players.

Both the Labour and National governments that have been in office have given our ideas careful consideration, not always agreeing with them but willing to discuss issues on their merits. Political partisanship one way or another has not been in question. This, I believe, has been a key to any effectiveness we may have had. An important factor has been a willingness to persist fearlessly with arguments despite knee-jerk and dismissive reactions to them. Such reactions were particularly a feature of the Muldoon era in New Zealand and seem to plague Australian political life far too often today.

My observations on the economic policy debate in Australia would suggest a good deal of frustration among business that its views are often not being listened to, far less heeded. It's tempting in this situation to abandon, or at least temper, the policy prescription and instead seek greater involvement in decision-making processes - the so-called politics of inclusion. This may make sense if there is something wrong with the message, but not otherwise. Changing tack and seeking to be loved will only leave business representatives in the position of the miserable creature Ronald Reagan described as the fellow who hoped the crocodile would eat him last.

It would be better to re-examine how the views of the business sector are being prepared and marketed. Is the background research of unimpeachable quality and consistency? Are the results being debated and accepted within the appropriate professional circles? Have adequate efforts been made to communicate and explain them to the media and the public?

On the basis of New Zealand's experience, there is no reason for pessimism about the prospect of even quite radical ideas being taken up and finding their way into policy. What is politically impossible today often becomes conventional wisdom tomorrow. Business must be in for the long haul.

The tide of ideas is still running strongly in the directions which began to influence policy in the 1980s. For the first time this century, collective governmental action is not seen as the solution to most problems; rather it is often seen as their cause. Many societies are now engaged in the enterprise of evolving a new liberal vision of what governments should do and what institutions should govern the interactions of citizens in a free society.

This is not an anti-government vision: it is one that affirms a governmental role as rule-setter, supplier of public goods and guarantor of a basic safety net. However, it seeks to limit government to those functions that only governments can undertake, and to insist that they are performed well. There is a disillusionment today with governments because they have tried to do too many things, and ended up doing them badly. The vision is not a purely material one either: it is one that reaffirms the basic goals of freedom, security, justice, equity, and a good environment, as well as economic welfare.

The evolution of a coherent vision will present many challenges and take many years to implement. Businesses are the wealth-creating institutions of our societies. If businesses and business organisations are not prepared to present and defend a vision of how we can better achieve prosperity and security, who will? I hope you will take up those challenges and contribute to the reform agenda that both our countries need. In an ever-changing world it is a task that has no end.

ROTARY CLUB OF NEW LYNN

IS NEW ZEALAND NOW IN THE SAME LEAGUE AS THE ASIAN TIGERS?

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AUCKLAND
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IS NEW ZEALAND NOW IN THE SAME LEAGUE AS THE ASIAN TIGERS?

I have chosen this evening to speak on the topic: "Is New Zealand now in the same league as the Asian tigers?" This is not meant to be a question about a new football code. It's a question about how good New Zealand's growth prospects now are following the policy reforms we have been through over the last decade or so. Are we likely to match those Asian countries - the so-called 'tiger' economies - that have consistently been setting the pace for the rest of the world?

The topic is of interest because the material living standards of all New Zealanders depend ultimately on economic growth, that is to say increases in GDP or the total production of goods and services in the economy. More precisely, they depend on growth in income per head, allowing for changes in population. Leaving aside any improvements in our terms of trade and any appreciation of the exchange rate which increases the purchasing power of what we produce, higher effective incomes can only come from higher per capita production. In turn, higher levels of income and production per head in the long term can only come from improvements in productivity, the amount produced per person employed.

Labour productivity can be raised by investments in human and physical capital. The first requires a personal commitment to learning and change. The second requires the creation of a favourable investment environment - one which increases the supply of savings available to New Zealand and encourages entrepreneurs to use those savings to increase the stock of productive capital.

In the two decades 1960-1980, the average annual growth rate in real income per head in New Zealand was 1.8 percent. In the same period, the small Asian economies, Hong Kong and Singapore, averaged 6.8 percent and 7.5 percent respectively.

A comparison for the eleven years from 1980 to 1991 is even more unfavourable for New Zealand. Our real income per head grew by only 0.7 percent a year in that period whereas Hong Kong's grew by 5.6 percent and Singapore's by 5.3 percent.

The upshot is that the living standards of these two Asian countries, which in 1960 were amongst the most poverty-stricken in the third world, now exceed New Zealand's - at least as measured by per capita incomes. In 1992, the latest year for which comparable figures are available, income per head in Singapore was US$15,730 and in Hong Kong US$15,360, compared with US$12,300 in New Zealand. Adjusted for purchasing power, which arguably gives a truer picture of relative income levels, Singapore's per capita income was 16 percent above New Zealand's level and Hong Kong's was nearly 40 percent higher.

Singapore and Hong Kong and the two other tigers, Taiwan and Korea, followed Japan in achieving exceptionally high economic performance in the post-war period. Between 1960 and 1985, real income per capita increased more than four times in Japan and the four tigers. In recent years the three newly industrialising countries of South-East Asia, Malaysia, Thailand and Indonesia, have been following in their wake.

Not only have these countries grown fast but they have been exceptionally successful in sharing the fruits of growth. The distribution of income in the eight countries mentioned narrowed by as much as or more than in other developing countries, with the exceptions of Korea and Taiwan which began with highly equal income distributions. They are the only economies that have combined high growth *and* declining inequality. Moreover, the East Asian economies with the best growth performance, Japan and the four tigers, also have the most equal income distributions of the group.

There has been a huge amount of research undertaken by economists over the past few decades examining what factors matter most in determining why some countries, for example the Asian tigers, have much more successful growth records than others.

The World Bank drew a lot of this work together recently in a report entitled *The East Asian Miracle*. This study is an important one even though some of its conclusions are ambiguous and have been interpreted in different ways.

The report reflects the fundamental change in recent years in the worldwide debate between those advocating more government intervention and those who want less. This long debate is no longer about central planning versus markets. Even those still favouring a high level of intervention recognise that it will be damaging unless it occurs in 'market friendly' ways.

There is now a consensus that certain policy fundamentals have been of critical importance in encouraging the high levels of private investment and rapid skill development which have been important features of East Asian economies. The World Bank lists these as including macroeconomic stability, low barriers to international trade, low taxes, efficient public administration, and strong security of people and property.

New Zealand's policies in these areas are now much better than they were a decade ago:

- macroeconomic policies are stable - inflation is low, government surpluses are being generated and public debt is being repaid;

- trade barriers have fallen substantially and further reductions have been announced;

- statutory rates of income tax have been reduced as a result of a broadening of the tax base and further reductions are in prospect given continued improvements in the fiscal position;

- the efficiency of public administration has been greatly improved and many services previously provided by the government at a high cost to taxpayers have been put on a commercial footing; and

- although crime rates are of concern, the security of people and property in New Zealand is superior to that in most other countries.

Not surprisingly, with this improved set of policies the economy has been performing much better. Even in the ten years 1984-94, the economy recorded average annual real GDP growth of 1.6 percent despite massive restructuring, a slight increase on the 1.4 percent rate in 1974-84. The argument that New Zealand experienced pain but no gain is invalid on this basis alone. More importantly, output growth has been running at an annual rate around three times higher than the average of the previous twenty years. There are no signs of pressures which would bring the expansion to a halt.

However, the interesting question is whether New Zealand's policy reforms, impressive as they have been, are likely to enable us to achieve Asian tiger rates of growth and to regain the place we once enjoyed in the top rankings of higher income countries. One way of considering this question is to compare the quality of New Zealand's policies with those of the high performing Asian countries. In the recent budget, the government said New Zealand's economic performance was based on five fundamental policies. How do they compare with the typical configuration of policies in the Asian countries?

The first pillar of New Zealand's economic programme is price stability, the aim of the Reserve Bank Act. In the eleven years to 1991, inflation in New Zealand averaged over 10 percent per annum compared with 1.5 percent in Japan and 1.9 percent in Singapore. Since then, however, New Zealand's inflation record has been extremely good. While the overall inflation record of the East Asian countries has been good compared with most OECD countries and looks like staying that way, New Zealand may now do at least as well or even have an edge, provided the Reserve Bank Act is not tampered with.

The second policy pillar is fiscal discipline, in particular debt repayment. New Zealand's high level of net public debt led to three successive downgrades of our credit rating since 1983, and we have since only recovered one notch. Debt is now falling fast, although it is still expected to be around $8,500 per head in 1995/96 and the government's long-term aim is to reduce net debt to below 20 percent of GDP. By comparison, in the East Asian countries, with occasional exceptions such as Korea, debt has not been a problem. Hong Kong and Taiwan have massive and arguably excessive reserves. Hong Kong would be able to finance present levels of government spending for several years without raising another dollar of tax.

In respect of the third pillar, taxation, New Zealand now has a well-designed tax system with two broad tax bases, income and consumption, and more uniform rates on each. However, the level of taxation in New Zealand is extremely high compared with most Asian countries. This year total tax revenues in New Zealand are forecast to be around 35 percent of GDP whereas the tax burden in many Asian countries is typically not much more than half that level. High taxes distort incentives to work, save and invest and are a major reason for the sluggish performance of the highly taxed European economies compared with the fast-growing economies of Asia.

The fourth key policy being pursued by the government is the development of an open, enterprise economy. New Zealand has dismantled import controls and is lowering tariffs. However, tariffs remain high on a number of goods and are not scheduled to be eliminated until some time after the year 2000. By contrast, Singapore has been a free trade economy for 15 years and Hong Kong for even longer, and although other Asian countries still have trade barriers they have pursued outward-looking policies for many years and are progressively lowering them. Moreover, on the other side of the ledger, New Zealand maintains extensive regulations and monopoly controls over the export of our main primary products, which account for a large share of total exports. These limit competition and innovation, and have no counterparts in the East Asian countries.

The final pillar of the government's policy is the more flexible labour market created by the Employment Contracts Act. The ECA has been enormously important in increasing productivity and employment growth, and has been a key factor in the fall in unemployment from its peak of nearly 11 percent of the labour market to 6.6 percent today. However, the East Asian countries have never had the rigidities formerly associated with New Zealand's labour market and have maintained virtually full employment and fast growth in real wages. Typically they are not hampered by the kind of job-destroying interventions associated with our Employment Court and minimum wage legislation.

On the basis of this checklist, therefore, New Zealand scores well by comparison with the tiger economies only on inflation, and compares unfavourably on the other counts, particularly debt and taxation. That gap will take many years to bridge. Moreover, in three other areas besides those on the government's list, New Zealand's policies are less conducive to growth and good social outcomes.

First, the state-owned enterprise sector is much larger in New Zealand than Asia, despite recent trends. In 1984, SOEs accounted for around 12 percent of GDP in New

Zealand compared with 3 percent in Asia. The New Zealand figure has now come down to 5 percent of the economy, but Asian countries have also been privatising rapidly. At 5 percent of the economy, the SOE sector is half as large as the combined share of economic activity represented by all the firms on the Business Roundtable. Moreover, local authorities also own substantial commercial operations. The evidence is now clear-cut that, on average, private enterprises are more efficient than SOEs and New Zealand is sacrificing potential growth by not proceeding more rapidly with privatisation.

Secondly, last year's World Competitiveness Report put New Zealand in third place for the quality of government policies and ninth overall, but only in 17th place on the criterion of how well the education system meets the needs of a competitive economy. Singapore was ranked top on this criterion, and Japan, Hong Kong, Taiwan and Malaysia were all ahead of New Zealand. Asian education is noted for its quality, especially in vocationally and technologically sophisticated disciplines, and has not fallen prey to the so-called 'progressive' trends in education in New Zealand and some other western countries.

Thirdly, while several of the East Asian countries have a basic state safety net, all have avoided creating a western-style welfare state. Lew Kuan Yew regularly warns that a slide towards welfarism would spell an end to Asia's increasing prosperity. The values of saving, enterprise and personal and family responsibility are accordingly much more entrenched than they are in New Zealand. The result is not only a far smaller burden on government budgets but also a superior range of social indicators. Crime, divorce, illegitimacy and unemployment rates are typically well below New Zealand figures. Curiously, most church and welfare groups in this country seem largely uninterested in welfare that works, and remain ideologically wedded to state welfare.

In my view, the combination of these factors means that New Zealand is likely to continue to trail well behind the high performing Asian economies in the period ahead, barring political developments which might throw any of them off course. They are continuing to deregulate, privatise and reduce tax burdens. As a country, we ought to take stock of whether we are content with the progress of the last ten years or whether we want to set our sights on joining the top league.

Let me illustrate the prizes at stake in the following way. In the early 1980s, I was involved in an exercise in the Treasury aimed at forecasting New Zealand's economic growth in the fifteen years ahead. Our estimate was an average of 2 percent a year. Based on the government's figures in the recent budget, annual growth in GDP in the fifteen years to 1996/97 is likely to average 2.1 percent, almost exactly in line with the forecast.

My guess is that the reforms of the last decade have lifted New Zealand's likely average growth rate in the next fifteen years to around 3 percent a year. The average for the next few years may be a little higher as unemployment falls and workforce participation increases, but the current policy paralysis and the risks of backsliding are dampening our longer-term prospects.

It has to be emphasised that a move from a 2 percent average growth rate to a rate of 3 percent represents a vast improvement. Over fifteen years, compound growth at 3 percent per annum translates into an economy that is 56 percent larger compared with an economy only 35 percent larger if 2 percent growth were achieved.

However, the government's target of achieving 3.5 - 5 percent growth would translate into much higher figures - an economy between two thirds larger and twice the size of today's economy over fifteen years. I have no doubt that such a performance or better could be achieved. But I concur with Gareth Morgan's comment in last week's *National Business Review* that:

> The momentum of ongoing reform the government has going now is simply inadequate to lift the non-inflationary growth rate to the 5 percent rate dreamt of in National's ... planning fantasia.

In my view it would be folly to think that New Zealand has been through all the 'pain' and can now safely sit back and wait for the 'gain'. Our economy is in much the same condition as a person who has just recovered from a long illness. We are basically, healthy again but not in peak condition. There is a risk that our lack of fitness in some areas will cause us problems. We also run the risk of acting like members of sports teams who are so confident of winning that they forget to train, and spend the prize money before they have earned it.

The Asian tiger economies may slow down at some point but at present they are showing no signs of dropping their training regimes and going on a binge. Singapore expects to sustain a growth rate of 5 percent a year. Although fast growth is difficult to achieve at high income levels, it is possible that some of the Asian economies could maintain high growth rates beyond the point where their income levels have surpassed those of the United States and Japan.

If New Zealand wants to become a high productivity, high income, high employment economy, there is no reason why we could not achieve those goals. Sound economics, our own reform experience and the lessons from Asia all point the way forward. No one would advocate following Asian models for their own sake, and there would be aspects of their development we would wish to avoid. The relevant question is what is best for New Zealand.

My answer to that question is that we should make the most of our own opportunities and press on with policies that would strengthen the economy and help those who are still struggling. New Zealand is still far from having the best possible set of economic and social policies. Others might want to advocate a halt to further changes, or to argue that New Zealand should turn its back on the idea of becoming an open, competitive economy making our way in world markets.

Both views should be debated. All we should ask is that the consequences of the alternative choices are made clear to the electorate. The first option would offer the prospects of the growth with equity that the Asian tigers have achieved, but it would require a willingness to keep on adjusting to the world around us. Change is always uncomfortable for some. The second option might be less demanding in the short run but it would mean less progress in reducing poverty, debt, unemployment and social stress. Poor economic policies always hit those on low incomes hardest, however well-intentioned policy makers may be. Our relative living standards would slip even further and in all likelihood another economic crisis would loom sooner or later. We have been there and done that. Do we really want to repeat the experiment?

ROTARY CLUB OF CHRISTCHURCH

TEABREAK OR TRIPLE A?
- A COMMUNITY DECISION

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

CHRISTCHURCH
2 MAY 1995

TEABREAK OR TRIPLE A? - A COMMUNITY DECISION

I don't believe I need to spend time today establishing that New Zealand is becoming an economic success story. 'From cot case to case study' more or less sums up the progress of the last decade.

The economy is still forging ahead. Confidence is steady, investment growth is strong, and unemployment has been falling rapidly.

To be sure there are growing pains, but they are more bearable than the pains of not growing or the pains of restructuring.

For example, higher interest rates have hurt borrowers, but we must remember that they benefit savers, and they are the price to be paid for avoiding a resurgence of inflation and another boom and bust cycle.

Similarly, any rise in the real exchange rate puts pressure on exporters but it is one of the mechanisms by which the benefits of the improved performance are spread to the rest of the community. It means cheaper imports in New Zealand dollar terms, more affordable overseas travel, a lighter foreign debt burden and lower interest rates than would otherwise be necessary to control inflation. It also means it is more expensive for foreigners to buy New Zealand assets - a point that some of those concerned about this issue appear to have overlooked.

As a community, we need to understand clearly the implications of these trends if we are to stay on course. For example, a firming exchange rate will force firms to continue to improve productivity and innovate, or release resources to others that can do better - just as it has in Germany and Japan in the last 30 years. These are the ways in which living standards rise.

Likewise we need to understand that movements in the CPI by themselves have no implications for wages, any more than they have for rents, dividends or other incomes. Wages should rise where labour is scarce, but in many parts of the labour market the priority should still be to absorb the unemployed.

I am reasonably optimistic that these issues are now fairly well understood and I see no serious threats to the short-term economic outlook. I am less sanguine, however, about the longer term. There seem to me to be two kinds of danger to which New Zealand could fall prey.

The first is the ever-present risk of incremental backsliding. The economic crisis of 1984 did not happen overnight; Muldoonism was a case of death by a thousand cuts. It is common for countries to lose their grip. Australia was a model of fiscal discipline a few years ago; today it is in deep trouble with its budget.

It's easy to list examples of how New Zealand could go backwards. Shortly the government will be looking at ill-conceived proposals to regulate retirement income products and company takeovers, both of which would make our capital markets less efficient. There are dangers of re-regulation of our telecommunications market, yet the main problem with it is a form of old-fashioned price control embodied in the Kiwi share. The Employment Court is doing its best to make it harder for firms to employ people. Property rights are becoming less secure as a result of the operation of the Resource Management Act and Treaty of Waitangi processes, thus increasing investment uncertainty. Opposition parties are promising to increase government spending, raise tax rates, restrict overseas investment, change the Reserve Bank Act and repeal the Employment Contracts Act. Developments of this kind could easily return New Zealand to a level of mediocre economic performance, if not worse.

The second danger is that, even if it avoided these mistakes, New Zealand could just sit back and complacently rest on its laurels. We did that for many years while country after country passed us by. We have an enormous distance to go to lift our productivity performance and living standards to those of the top performers. Our average per capita income is only 70 percent of Australia's, half that of the Scandinavian countries and one third of Switzerland's.

Catching up means continuing to adjust and innovate. As a community we have still not developed the willingness to embrace change that characterises the dynamic Asian countries. Our culture seems to bear out the observation of the novelist John Steinbeck:

> It is in the nature of a man as he grows older to protest against change, particularly change for the better.

But as management guru W E Deming once said in response to complaints about change: "You don't have to do it: survival is not compulsory."

Today other countries are also forging ahead, making the kind of economic reforms that New Zealand has implemented and going beyond us. I do not believe New Zealanders lack aspiration and would be happy to settle for another teabreak and for mediocrity, if they understood the consequences. In a poll which the Business Roundtable commissioned last year, over 80 percent agreed that New Zealand should aim for a triple A credit rating. But if we want a triple A rating and the performance that goes with it, we will need political leadership and community understanding both of the case for change and its rewards.

Straightforward economic lessons must be widely understood if a country is to make economic progress. In a democracy, policy makers cannot be very far in front of public opinion. Business and community organisations, our educational institutions and private individuals all have a role in raising the level of public debate on economic issues. So too does the media. As has often been said, if it doesn't happen in the media, it doesn't happen.

It is instructive to research the role of the media in the economic reforms of the last ten years. Did the media understand the issues, explain them to the community, support desirable reforms and put a light on the hill to show the way to the public and politicians? To examine these questions, I will concentrate on the record of *The Press*, but for no reason other than that it is the local paper.

For the last couple of years or so, *The Press* in its editorial columns has generally been a signed-up supporter of New Zealand's economic directions. At the end of 1993 it was speaking of "a dramatic turnaround in the country's fortunes." It said it was "increasingly likely that there will be no back-pedalling on the existing policies that have been responsible for the economic recovery."

Can we therefore take it that *The Press* helped chart the way for those reforms and stood by the reformers through thick and thin? Well, not quite.

Going back to 1984, we find that *The Press* was broadly supportive of compulsory unionism: "The advantages of the provision probably outweighed the philosophical objections to it." It was sympathetic to manufacturers' opposition to reducing tariffs; the Treasury position was described as "hardline." *The Press* opposed raising electricity prices to competitive levels; this would be "wildly out of touch with what is economically necessary", it said. If a goods and services tax were to be introduced, it argued that "a number of basic items such as foodstuffs would have to be exempted."

The following year we find *The Press* supporting the retention of stabilisation funding for farmers. There would be "havoc" if some smoothing-out were not possible, it said, and to this day it has remained lukewarm about producer board reform. In looking at the debate over the Electricity Division of the Ministry of Energy, it asked whether there was any "particular virtue in a corporation as opposed to a Government department." *The Press* was clearly doubtful, seeing the argument as to some extent "ideological." Earlier it had maintained that the Tourist Hotel Corporation was "a key element of New Zealand's tourism industry."

The Press kept up its opposition to corporatisation. In 1988 we find it arguing that "the rush into corporatisation for airways services and the taxation of required profits on running airports are certainly going to push up the cost to consumers." It lamented the proposed sale of Petrocorp to British Gas in an editorial headlined "Vital industry going abroad."

The Press criticised the removal of tax concessions on superannuation, being uncomfortable with "a strictly even-handed approach to savings generally." In 1990 it argued against the 0-2 percent inflation target, claiming "the futility of fixing an inflation goal in isolation from the outside world." It proposed an inflation target of 5 percent.

In 1991, *The Press* was cautioning Australian Liberal Party leader John Hewson over the adoption of "international New Right" policies: "It cannot yet be said that the long experiment to which [New Zealand] has been subjected has worked." At the end of the year it criticised the prime minister who had stated, correctly, that an economic recovery was underway; Mr Bolger was "too optimistic in his assertions." *The Press* labelled itself a critic of "monetarism" and argued that "creating more jobs and stimulating economic growth are more important than a modest rise in the level of inflation." It hoped that the government "may yet accept responsibility for intervention to the extent of influencing interest rates and the exchange rate."

Little over a year later, however, *The Press* was cheerfully reporting "business confidence at its highest level for two years" and approvingly quoting Reserve Bank governor Don Brash as saying that the climate for sustainable growth in New Zealand "has never been better." Nevertheless, while not wanting the extremes of Muldoonism, it was pushing for "modest intervention, aimed at stimulating housebuilding." Around the middle of the year we find it arguing for a compulsory superannuation scheme, "hopefully sooner rather than later."

In the context of the 1992 Budget, *The Press* urged the government not to be influenced by "Right-wing pressure to refuse to consider even a marginal increase in tax rates." It approved the entertainment tax introduced in that year's budget.

The Press then seemed to have some trouble working out whether the country was on the mend or not. Late in 1992 it lugubriously observed that "The country is in for many lean years and will probably never return to the times of plenty." Its 1993 New Year editorial, on the other hand, said that the previous year had been a turning point in the country's march which had seen the emergence of "a majority of New Zealanders who favour the new ways." However, it went on in that year to worry about the balance of payments being "New Zealand's Achilles heel."

More recently the editorial storyline has been more consistent as the success of the reform policies became undeniable. In late 1993 *The Press* wrote that "The Reserve Bank's present policy is responsible, but it will require a ceaseless vigil, and the willingness of the bank to act before any threatening inflationary pressures become entrenched." Last year it acknowledged that "The Employment Contracts Act has been responsible in no small measure for opening up the job market," and warned that meddling with the ECA and the Reserve Bank Act "would jeopardise the certain benefits the country is now receiving." (By contrast, in 1991 it had complained about the "excesses" of the labour reforms.) The end-of-year message in 1994 was that the economy had been growing at an "awesome pace". Last month *The Press* appeared to have a momentary loss of nerve when it began an editorial with the statement "The rolling recovery that underpinned a spectacular year for New Zealand in 1994 appears to have lost its impetus." It ended by saying "Reports of the death of the economic recovery, however, are premature by a long way."

It is sobering to reflect that if the economic prescriptions which *The Press* offered prior to the last couple of years had been followed, New Zealand would in all probability still be in dire straits. Of course *The Press* also had many sensible things to say over the last ten years, including on economic issues, which must be set against this somewhat embarrassing catalogue. A New Year's Eve editorial in 1993 on welfare was quite outstanding and it has often written well on education issues. Moreover, *The Press* is one of our better newspapers and I have no wish to single it out. Until its change of editor in the early 1990s, *The Dominion*'s track record for economic commentary was far worse.

None of us gets it right all the time. My point is simply that the community's understanding of economic issues, which is necessary if we are to make progress, is not helped if an institution as important as the media lets us down. Newspapers may not be able to employ trained economists on their editorial staff but they have a duty to strive for informed, high quality economic commentary - or else not stray outside their field of professional expertise.

There are two footnotes that are worth adding to this narrative.

The first is that while we all make mistakes, most of us learn from experience and try not to repeat them. I mentioned the general hostility of *The Press* to corporatisation and a specific claim that corporatisation of airways services would push up the costs to consumers. The record is that in the five years following corporatisation in 1987, over $20 million of annual cost was stripped out of the Airways Corporation, and charges to the major carriers were dramatically reduced, in some cases by as much as half. Yet in February this year, *The Press* was making similar assertions about the water industry, which is increasingly being corporatised and privatised around the world. A study of one privatised British water company indicates that its charges are now some 13 percent lower on average than would otherwise have been the case. Rhetoric about water being more than "just another commodity" and "public assets being plundered for private gain" is a poor substitute for research and analysis.

The second footnote is the observation that in ten years of editorials, *The Press* seldom, if ever, offered a positive vision for New Zealand and discussed the means of achieving it. It was either a critic or, more latterly, a supporter of official policy, but rarely a catalyst with a positive agenda of its own. It poured cold water on the platform of ACT New Zealand when it was recently announced, dismissing it with a comment that the country was tired of reforms.

Some of our other newspapers are more like their counterparts around the world in encouraging governments and the community to raise their sights. The Auckland-based *National Business Review* and *The Herald*, for example, between them argue for privatisation of government businesses, more competition in health and education, producer board reform, the removal of the ACC monopoly, deregulation of postal services, and fire service reform, all of which would move New Zealand closer to Asian levels of economic performance. *The Dominion* last year said that this was "No time for a breather." The South Island papers seem mainly content with the status quo. *The Press* did say in an editorial last year that to ensure New Zealand achieves the government's target of 3.5 to 5 percent annual growth "New Zealanders must discuss and debate the factors that will cause it," but we are still waiting for its contribution to that debate.

If New Zealand is to avoid an MMP siesta, more organisations and individuals are going to have to do the hard work of understanding economic and social issues, be prepared to debate them and create an environment where politicians are able to implement further changes - or indeed are unable to resist a consensus that change should occur.

For its part, the Business Roundtable will continue to put forward ideas which we think would be of national benefit. We have never been afraid of controversy. Many times our proposals have initially been met with reactions such as "too extreme," "off-the-wall" or "politically impossible." Often we have seen them debated more rationally over time, picked up by others, and become accepted as the conventional wisdom.

Old habits die hard, however. A couple of weeks ago, the Minister of Internal Affairs, Warren Cooper, reacted to a report of ours on the fire service by describing it as being in "fantasyland." He added:

> By now nothing surprises me when it's created by the Business Roundtable. ... [I]f the Roundtable were to be believed, the next step for privatisation would be the police, and then the armed forces, which could be sent out as mercenaries on individual contracts.

I keep a scrapbook of vintage no-brainers of this kind. An earlier entry only three years ago was due to Mr Cooper's predecessor, Graeme Lee, who told us to "keep our nose out of Fire Service affairs" when we first raised the issue. He denied there was any need for change. Today even the Fire Service agree they can save $29 million dollars a year, a whopping 17 percent of their total costs.

If one of our ministers of the crown cannot distinguish between a service which delivers essentially private benefits and services which are essentially public goods, and which require a power of coercion that can only be entrusted to the state, then we are in bad shape. All the options for reorganising and financing the fire service which we proposed can be found around the world, and in some cases are commonplace. We will certainly not be cowered from debating such issues. Too many people kept their heads down during the Muldoon era when Mr Cooper learned his politics and abuse substituted for argument.

Other experiences are more encouraging. One which I had recently, following an address to the Auckland Manufacturers Association, was particularly gratifying. In proposing a vote of thanks, an elder statesman of the manufacturing industry spoke along the following lines:

> We used to fight tooth and nail against the policies the Business Roundtable has promoted but we were wrong. They have created the best environment New Zealand manufacturers have ever known. We must support them in their efforts to maintain and improve it.

The thrust of my remarks has been that whether New Zealand opts for a teabreak or a triple A level of economic performance is a community decision. It's hard to believe that New Zealanders would go for the teabreak option if the issues are presented to them clearly, objectively and intelligently. Those who are still struggling will not be helped by inertia. There is no economic reason why New Zealand could not match the performance of the fast-growing, fully-employed Asian economies. The basic requirement is to keep on developing the kind of policies that we have implemented in the last ten years and which in many cases are similar to theirs. For governments to do so, they will need to have the backing of broad sections of the community, particularly in the MMP era. In other words, it is up to us if we want to see it happen. As Abraham Lincoln once said:

> Public opinion is everything. With it, nothing can fail; without it, nothing can succeed.

AUCKLAND CHAMBER OF COMMERCE

MOVING INTO THE FAST LANE

DOUGLAS MYERS
CHAIRMAN
NEW ZEALAND BUSINESS ROUNDTABLE

AUCKLAND
2 MARCH 1995

MOVING INTO THE FAST LANE

It's a pleasure to speak to an audience which reflects such a wide cross-section of the business community. One of the most pleasing developments of recent years that has accompanied the resurgence of business in this country has been the resurgence of business organisations. Almost all of them have gone through a process of upgrading and modernisation. Today they are in basic accord on the economic fundamentals that New Zealand needs for business success and growth.

I want to pay tribute to the Auckland Chamber of Commerce which, under Michael Barnett's leadership, has been part of this process. It represents businesses large and small. Contrary to the beliefs of those who would play one group off against another, large and small businesses have the same aspirations. The Business Roundtable is working with the Auckland and Wellington Chambers on a study which reviews New Zealand's recent achievements and looks at how we can build on them. We share the same goal of seeing the country really move into the fast lane.

It has to be said that those achievements are phenomenal. The big story in New Zealand today is that the benefits of economic restructuring are now undeniable. In calendar 1993 the economy grew by about 5 percent; growth last year seems likely to come in at just below 7 percent; and this year looks like being another 5 percent year. The appreciation of the exchange rate means our effective income has risen faster still. In just three years the economy will have grown by more than it did in the ten years to 1984 - the so-called 'good old days', when even this miserable growth was fuelled by rising debt.

Even more important, present growth is being sustained. The government's current forecasts imply an expansionary phase of 7 years since the economy stopped contracting in 1991. Previous expansions since 1965 lasted an average of about 18 months. We have broken the stop/go cycle.

The quality of the present growth phase is exceptionally high. There are no evident inflation or balance of payments pressures that put it at risk. Business investment has been growing at around 15 percent a year; export growth is matching the growth of imports; New Zealand's credit rating has been upgraded; the budget is in surplus; national savings are rising; company profitability is high and company balance sheets and cash flows are strong. The migration outflow has turned around and there is strong interest in immigrating to New Zealand. Prices are no longer sending wildly distorting signals, firms can react quickly to changing market demands, and competition is forcing continuous innovation. None of us in business today has ever seen New Zealand in such great shape.

The best news of all has been in the labour market. Contrary to those who talked about a jobless recovery, job creation has been nothing short of spectacular. Since the Employment Contracts Act was passed, some 140,000 new jobs have been created, the equivalent of the entire work force of Wellington or Christchurch. The government's December economic update predicts a further 135,000 jobs will be created by 1998. The unemployment rate in 1991 was nearly 50 percent higher than it is today. New Zealand is working again.

I will come later to the challenges we still face, and there are plenty of them. But the point to be made at this stage is that New Zealand has come through a remarkable transformation. We are finally out of the tunnel and into the light. Polls show that New Zealanders are happier with their lives than they were ten years ago, they think their country is going in the right direction, and they have more pride in it. These are the results that some of us have worked for over many years. This is New Zealand on the change.

It has still not dawned on some that the achievements in New Zealand are of international significance. Provided we can keep the momentum going, they stand to rank with the economic successes of Germany and Japan after the war, Chile and the tiger economies in the 1970s and '80s and the Czech Republic today. As *The Asian Wall Street Journal* said recently, it's only a decade since New Zealand was the sloppiest, most terminal welfare state in Christendom. We are now rising fast in the world competitiveness rankings, and are at the top of the OECD countries for the quality of government policies.

New Zealanders in all walks of life have come to accept there was a need for change and have shown that kiwis can fly. Our farmers, manufacturers, state-owned enterprises, local governments, polytechnics and media organisations, to give but a few examples, are all doing a far better job than they were ten years ago. Ordinary New Zealanders are the unsung heroes of the turnaround.

Many of our politicians also deserve a special tribute. It's time to hit back at those with other agendas who have sought to bring politics in this country into disrepute. We have had some exceptionally courageous and far-sighted politicians in the last ten years. The average quality of those who have served in parliament in that time is far higher than it was in the 1970s and early '80s. Visitors to the country who meet with our politicians routinely comment on the intelligent grasp of economic realities that many of them display. Naturally we are all keen to see them do better yet; we are always wanting to lift the bar. But we should give recognition for what has been done, and say 'thank you' for their achievements.

As people in business, however, all of you in this room are only too aware that what counts for the future is not your past achievements but your firm's potential for improvement relative to its competitors. Exactly the same is true of countries. As one fund manager said after a recent New Zealand investment conference in Australia:

> All I've heard is what your country has done over the past ten years. What I really want to know is what happens now.

The unforgiving answer, if we want to extend the gains and reduce the risks to which New Zealand is still exposed, is that we have to keep on raising our sights. In business today, the only relevant benchmarks are the world's best. If you don't meet them, you pay a price. Countries that settle for less face the same penalties. From being richer than Australians, our per capita incomes are now around three quarters of theirs. The New Zealand dollar, which was worth A$1.24 in 1967, was worth less than 60 cents by 1984 and has regained only part of the lost ground. Do we always want to be poorer than Australians?

When he spoke to this audience last month, the prime minister said that it would be necessary to ease back on the present rate of growth. Surely this cannot be the logical stance. If I were to tell my board or shareholders that I wanted to see the company's performance ease back, I suspect they would start looking for a new chief executive. Why then should we accept the prospect of drifting back into the cruising lane? Why don't we really put our minds to moving into an Asian-style fast lane?

There is no doubt that we can improve our performance a great deal yet - probably by as much in the next ten years as we have since 1984. Our average levels of productivity, and hence our income levels, are still far below the world's top performers. We will certainly not be doing all we can for those who are still unemployed or struggling to make ends meet if we just switch into cruising mode.

The government has set an annual growth target of 3.5 to 5 percent for the period to the year 2010. Even if we were to accept that target, it means that we will need years of growth of above 5 percent to offset years when growth falls below the bottom of that range. If we moved above the top end of the range we could overtake Australia by 2010. As Roger Douglas is saying, we could scrap our personal and company income taxes in that time. People would have more to spend on health, housing, the environment or anything else they valued. With a highly productive economy, you still can't have it all, but you can have a lot more.

What would we need to do to move New Zealand up to world class standards of performance? The answer is now very clear: we must keep concentrating on the economic fundamentals, just as the best performers in Asia and elsewhere do.

There are four key pillars to the current economic framework, all of which can be strengthened.

The first is to create a fully open economy. We have made much progress in this direction, and Philip Burdon deserves credit for the tariff decisions at the end of last year which signalled a move to full free trade soon after the turn of the century. Our international tax regime, which in effect applies a tariff to imported capital, now needs to be brought into line with the needs of an open, competitive economy. The moves on tariffs must be matched by moves to dismantle controls over primary exports. The primary sector's performance is now lagging well behind the rest of the economy; in the last twelve months it actually lost jobs. The government's December update noted that the value of non-commodity manufactured exports in 1997/98 is forecast to be larger than meat, wool and dairy exports combined - an astonishing projection which has gone almost unnoticed. In the single-desk industries the problem is that farmers are confronted by trading monopolies; they don't have competitors bidding for their products. Like the Loch Ness monster, an efficient, dynamic monopoly has not yet been sighted, though many farmers still seem to believe in its existence.

The second pillar is the Reserve Bank Act and its goal of price stability. The benefits of the low inflation environment have been immense. Some of our more flighty economic commentators have been fretting that the rise in interest rates may choke off growth. Memories in this country are very short. Nothing did more to choke off growth than the inflation of the 1970s and '80s. The reactions of the market and the Bank to keep the economy on a non-inflationary path provide the best guarantee of growth being sustained. The Bank can do without fairweather friends. We will know it has over-reacted if underlying inflation moves below the 0-2 percent range. Unless and until that seems likely to occur, the business sector should be giving the Bank its full support. It should also work to persuade Labour and the Alliance to drop their plans to tinker with the Act.

The third pillar is fiscal discipline. This was lacking up to 1991, and has been absolutely fundamental to the subsequent progress.

Contrary to some views, fiscal discipline is not the enemy of good social policy; it's an absolute precondition to the delivery of good social outcomes. It cannot be emphasised too strongly that the key issue in fiscal policy is what the government spends rather than how much it receives in taxation. Unjustified government spending is the real burden on the economy, whether it is financed from taxes or borrowing. Borrowing just defers the tax which has to be raised to repay the loans.

The growth in government spending in New Zealand and many OECD countries has severely impaired their economic performance. The former deputy-editor of *The Economist*, Norman Macrae, has pointed out that in the 1870s Gladstone's supposedly left-wing Liberal government absorbed 6 percent of Britain's national income in government expenditure. In Britain and New Zealand, spending by governments at all levels reached well over 40 percent of national income in the 1980s, and regulatory burdens have also grown enormously. The lower government spending and regulatory burdens of the Asian countries have been important factors in their growth performance and in their attractiveness as locations for business and investment. New Zealand now faces this new form of international competition. As Macrae put it:

> Countries that choose to have too high taxes or too fussy regulations will be residually inhabited mainly by dummies.

(He was not referring to those objects seen in shop windows with clothes on them.)

When the Business Roundtable argued in 1992 that New Zealand should aim to get its levels of government spending and debt down to below 30 percent of GDP by the year 2000, Helen Clark expressed shock and horror and the prime minister felt obliged to castigate us for being "too ambitious". Today the government is on track to reaching these targets within the next couple of years. New Zealand now has a real opportunity to reduce both debt and taxes. The crucial requirement will be to maintain tight control of government spending - tighter than last week's budget policy statement indicates the government is achieving. More than anything else, a lower expenditure and tax burden would take New Zealand closer to the Asian fast lane.

The final pillar of the economic framework has been the labour market reforms introduced under the Employment Contracts Act. Their contribution to enterprise trust, cooperation and productivity has been huge. They have been far more significant for job creation than anything coming out of the Employment Task Force. All of the dire consequences predicted by their opponents have failed to materialise. Business organisations such as the Manufacturers Federation which were largely uninterested at the time are now among the strongest supporters of the ECA.

All business organisations must redouble their efforts to expose the fact that proposals to amend the ECA reflect narrow vested interests, not the interests of workers, the unemployed and the community at large. They must also expose the fact that the courts are neglecting the same interests, thwarting the government's aim of creating an efficient labour market and causing the loss of thousands of potential jobs. With the Court of Appeal decision on redundancy compensation last year, there is now no doubt that the courts are at odds with the government's explicit policy intentions. This should be regarded as an undemocratic and intolerable state of affairs. One option open to the government, if it is determined to put the jobs of the Employment Court judges ahead of those of the workforce at large, is to allow appeals to the Privy Council, which would be more likely to uphold the word 'contract' in the Employment Contracts Act.

Beyond these four core areas, there is still much that can be done to keep New Zealand moving ahead. Other things being equal, the higher interest rates needed to contain inflation will dampen down activity somewhat. But other things need not be equal. The economy is now much more flexible and less prone to bottlenecks. Further steps could be taken to free up resources, upgrade skills, encourage higher investment and maintain the growth momentum.

The problem now is not that we do not know what to do; it is summoning the will to do it. Ministers state openly, for example, that they know electricity privatisation, which is being implemented in Victoria this year, would yield large benefits, but they are not prepared to explain and advocate it to the public. The advent of MMP could add to such paralysis. In a speech this time last year I said the political situation following the election seemed to leave the government in a predicament a bit like that of Pooh Bear, stuck in a rabbit hole after a meal of honey, unable to go forwards and unable to go back. Well, we haven't gone backwards, and the government even made some useful progress last year, but, with only a few obvious exceptions, we seem to be lacking politicians with a dynamic vision of what New Zealand could become. Today's political climate reminds me of a passage from *The Wind in the Willows:*

> "Beyond the Wild Wood comes the Wide World," said the Rat. "And that's something that doesn't matter, either to you or me. I've never been there, and I'm never going, nor you either, if you've got any sense at all. Don't ever refer to it again, please, Now then! Here's our backwater at last, where we're going to lunch."

The challenge for those who want to see New Zealand move into the fast lane to the Wide World, and not slip back again in the economic traffic flow, is to change this defeatist political climate. The onset of MMP is no excuse for inaction. If Sweden, a, country with proportional representation and a long socialistic tradition, can introduce broadly equal funding and open competition between public and private schools, why can't we?

If we are to move forward, particularly in the MMP era, there will need to be more community understanding and debate about the opportunities that could be grasped. As *The Herald* pointed out in a recent editorial, despite the evidence of economic success all round them, New Zealanders were still half-listening last year to the academics, counsellors and clerics who had spent the previous nine years deploring the reforms. You will recall that the Catholic Church refused to recognise that the earth went around the sun for 200 years after Copernicus proved it. There is now no excuse for ignoring evidence. We can do without the sermonising that poverty still exists - most of us in the business world are well aware of that, and have been putting our minds to solving the problem. It's not enough to be well-meaning if you haven't taken the trouble to understand the issues and keep coming up with herbal remedies which would only make the underlying problems worse.

People are steadily losing interest in those who have nothing to contribute. As someone said to me the other day, "I used to read an article by Chris Trotter and get angry. Now I just regard what he writes as irrelevant." But while we should ignore the ideologues, we should continue to address the concerns of open-minded New Zealanders who have not yet signed up to the reforms. In part, this involves explaining that some of the concerns are misplaced. For example, it is still frequently claimed that the benefits of the reforms have gone to a privileged few and are not being widely spread. Where this is not just Marxist dogma, it has no basis in reality. With the extraordinary rate of job creation, and the government's forecast in its December update that compensation of employees is expected to be $8.5 billion higher in 1997/98 than it was in 1993/94, huge numbers of New Zealanders are becoming better off. Similarly, complaints about a loss of national sovereignty overlook the fact that all of New Zealand's debt ratios are now falling, that we are less, rather than more, in hock to the rest of the world, and that our more robust economic position generally is restoring our control over our own destiny.

On the other hand, there are still genuine reasons for concern over poverty and inequality, but the task remains one of implementing effective remedies. There is general agreement, for example, that a prime cause of the increase in income disparities in the 1980s was the increase in unemployment due to the rigid labour market. The question to be asked of those concerned about that development is: "Where were you in the debate about the removal of those rigidities?" Today people speaking out on the subject should be supporting those who are pointing to the damaging consequences of the Employment Court's behaviour, minimum wage laws, restrictions on educational choice, open-ended welfare benefits and the like. The 'remedies' still being proposed by some - such as higher government spending and taxation - are the ones that got us into trouble in the first place.

There are other reasons why a broad approach is required. In many ways the economic debate is over, not just in New Zealand but around the world. Most countries are following broadly similar, market-oriented policies. Instead the focus has moved to a new set of social, cultural and moral issues. These have to do with the proper spheres of government, community, individual and family responsibility. Too often in the past we have confused these boundaries and forgotten that the fundamental basis of a free society and a healthy economy is the idea that most people, most of the time, are more than capable of knowing their own interests, and of working to satisfy their ambitions and bring up their families. To help with our understanding of these issues, the Business Roundtable is co-hosting a visit by the distinguished theologian and writer Michael Novak later this month. I urge you to listen to what he has to say. Much more effort must go into researching and debating these issues in the period ahead.

In all of this, I believe a new responsibility is falling on the private sector. For sound economic and moral reasons the business community has been arguing in recent years for less government. The corollary is that businesses and other private organisations must take up the slack. This is already happening. This Chamber, for example, has established a business mentor programme; Fletcher Challenge has introduced an excellent scheme to provide superannuation and health and disability cover to its employees; and firms are investing much more in training - $10 million a year in my own company's case. Many firms are involved in school-business partnerships. Stephen Tindall of The Warehouse is setting up a private scheme aimed at giving disadvantaged people a hand-up instead of a state welfare hand-out. We can expect to see many more initiatives of this type as tax rates fall and more resources are left in private sector hands.

I believe businesses are also going to have to devote more resources to the public policy debate, particularly in the MMP era. We have seen in the last ten years that the efforts to promote better policies have yielded high returns to their stakeholders and the community at large. There will always be some businesses who do not pull their weight and free ride on the efforts of others. That's life. But in areas where more progress needs to be made, such as health and education, there are well-resourced groups promoting their own interests rather than those of the community at large. The secondary teachers' organisation, the PPTA, which is an active participant in the education debate, has a budget of $4.5 million which is well over twice the budget of the Business Roundtable or the Auckland Chamber of Commerce. If business wants to engage effectively in these debates, we will have to ensure that the Chambers of Commerce and other business organisations are equipped to do the job.

There are no grounds to be complacent about the position New Zealand has reached. We could easily get lost in the Wild Woods again. We could persuade ourselves that we have had enough change, forgetting that constant adaptation to a changing world is the only guarantee of security.

On the other hand, we could as a community sign up to a much more ambitious vision for New Zealand, and make further reforms politically possible. Vaclav Klaus, the prime minister of the Czech Republic and the leading reformer in Eastern Europe, has spelt out the political task as he sees it:

> For the countries of Central and Eastern Europe, the important thing now is to push ahead with the process of self-transformation, and to resist any temptation to settle for half-measures or to make useless political and social concessions. The reforming politician must guard against "reform fatigue". He must be able to formulate a clear and lucid vision of a future which is both attractive and achievable; he must explain this vision to his citizens and defend it against populists of all shades; he must implement a consistent reform strategy and introduce unpopular and painful measures as and when they are needed; and he must not defer to rent-seekers and lobbyists who pursue their own short-term advantage to the detriment of society as a whole.

We have applied many of these lessons in the last ten years. In New Zealand's case, the ratio of gain to pain from here on should be much more favourable. Given vision and effort, there is no reason why good ideas and policy arguments should not continue to carry the day. Indeed there is every reason to believe that the economy could accelerate into the international fast lane. Why should we be willing to settle for anything less?

FISCAL POLICY AND THE PUBLIC SECTOR

HUTT VALLEY CHAMBER OF COMMERCE
AND INDUSTRY

SPENDING, TAXING AND ECONOMIC GROWTH

BOB MATTHEW
VICE-CHAIRMAN
NEW ZEALAND BUSINESS ROUNDTABLE

LOWER HUTT
24 JULY 1995

SPENDING, TAXING AND ECONOMIC GROWTH

It is a pleasure for me to participate in this opening function of the 1995 ANZ Bank Hutt Valley Small Business Week.

The Hutt Valley Chamber of Commerce and Industry deserves congratulations for promoting this business week, as does the ANZ Bank for its sponsorship involvement. We all have to work hard to explain the role of business in the community and promote an enterprise culture.

The opportunity to earn a profit is what motivates business, and profitability is the most important measure of its success. Some people still seem to find the idea of profits distasteful, perhaps even obscene. Obscene profits are hard to come by in today's competitive economy - though if anyone knows of such opportunities I would like to know about them, as my company can always do with a windfall profit boost! But does anyone really view the opposite result - loss making - as an indicator of success, and something that is in the interests of consumers and investors?

Businesses need to pay close attention to every aspect of their operations if they are to be profitable. But while many steps can be taken to improve the profitability of individual firms, the overall performance of the economy is the most important influence on the fortunes of businesses, small as well as large. While some firms and income earners may prosper when the economy is in the doldrums, by definition most will not. On the other hand, a dynamic, growing economy lifts incomes generally, just as an incoming tide raises all boats.

Responsibility for the performance of the economy rests with successive governments in the first instance, and ultimately with electors through the policies they vote for. Governments face a wide range of choices, and the policy choices they make largely determine the performance of an economy.

Consider the growth record of a few countries. At the beginning of this century, Canada and Argentina had similar per capita incomes. Canada's per capita income today is about US$20,000 whereas Argentina's is just over US$7,000. Shortly after World War II, the average living standards of Japan, the Philippines and India were comparable. Japan's income per capita is now over US$30,000 while in the Philippines and India average incomes are below US$1000.

People who earn relatively low incomes in Japan today enjoy a much higher standard of living than the vast majority of high income earners in either the Philippines or India. The beneficial effect on low income groups of sustained growth over the longer term is often ignored by those who claim that the benefits of growth are unevenly distributed. Their analysis is unduly static and narrow. While income distribution is relevant, it can never be an effective substitute for sustained economic growth.

There is general agreement today on the key ingredients of economic success. They comprise a firm commitment to price stability, openness to international trade and capital flows, fiscal responsibility, modest levels of government expenditure and taxation, and an environment which provides the maximum opportunity for individual initiative. They are proven policies that are certain to raise incomes.

The general thrust of New Zealand's economic policy since 1984 has been consistent with this prescription and the benefits are now clearly apparent to most people. If the 1995 budget forecasts prove to be accurate, real GDP will expand by 28 percent between 1991/92 and 1997/98. This is equivalent to an annual average rate of growth of over 4 percent. The current forecast reflects a vast improvement in economic performance relative to the past couple of decades. The present expansion of the economy has silenced those false prophets who kept telling us that there would be no gain from restructuring.

While investors and bankers properly acknowledge the past achievements of businesses, their primary focus is always on future plans and expected performance. They put more weight on their assessment of whether a business is likely to respond energetically to new opportunities and threats than on its historical performance. Similarly, electors should take a forward-looking perspective in evaluating the quality of economic management. They should ask whether the government is working hard to strengthen economic performance or whether it could do more.

The annual government budget process enables the stakeholders in New Zealand Inc to take stock of the prospects for the economy at large. The 1995 budget forecasts an annual growth rate for the next three years of 3 to 4 percent, which is still unexciting relative to the rates that could be achieved. The challenge is to raise the rate of growth without compromising the goal of price stability.

Many of the policies that have been implemented or are in train will contribute to that goal. We need to remind ourselves that the benefits of lower tax rates, tariff reductions and the increase in the age of eligibility for New Zealand superannuation, for instance, are still to be realised fully. However, further progress in implementing proven policies will be necessary if the government's goal of achieving growth in the range of 3.5 to 5 percent a year in the period to 2010 is to be achieved.

The Business Roundtable has outlined in a number of reports the sorts of policies that are required. They include, for example, changes to agricultural marketing arrangements, a meaningful privatisation programme, reform of the Employment Court, greater choice and competition in education, improved incentives to choose work rather than rely on welfare, and a reduction in low quality government expenditure.

The dynamic countries of East Asia have achieved substantially higher rates of growth than those forecast for New Zealand, and in general have a good inflation record. There is no reason why New Zealand cannot do the same if it continues to implement high grade policies.

One of the key policy requirements for continuing strong growth is tight fiscal discipline. We have seen major improvements in the government's fiscal position since 1991, and they have been a key factor in the economic recovery. However, there is a widespread perception that National and Labour governments slashed government spending between 1984 and 1995. In particular, Alliance spokespersons and others have said the improved fiscal position was built on the backs of welfare beneficiaries. Are these views correct?

Data on fiscal trends since 1984 is affected by the adoption of accrual accounting and by some large structural changes in the government sector such as corporatisation, privatisation and the reorganisation of health services. These changes affect the comparability of published data but are unlikely to have altered the general picture that emerges.

In nominal terms (that is, before adjusting for inflation) total government spending doubled between 1984/85 and 1994/95. It rose from $15 billion a year to $30.3 billion. When spending is expressed as a percentage of GDP, which adjusts for inflation and growth in economic activity, it fell from 37.8 to 34.7 percent. This amounts to an average decline of 0.3 percentage points a year and returns the ratio of spending to GDP to the level last recorded in the mid-1970s. This evidence does not support the claim that expenditure has been slashed in the last ten years.

It is also interesting to examine the records of Labour and National. Between 1984/85 and 1990/91, the ratio of government spending to GDP increased by 3.3 percentage points to 41.1 percent of GDP. Under National, the ratio of spending to GDP fell by 6.4 percentage points between 1990/91 and 1994/95. National therefore significantly moderated the increase in spending that had occurred under Labour and in the years before Labour took office in 1984.

Another common perception is that spending cuts have dismantled the welfare state. Is this perception correct?

The level of spending on social security and welfare, education and health is sometimes viewed as an indicator of the size of the welfare state. Comparisons in this area are also affected by changes in the classification of government spending, but again the general picture is quite clear.

During the past ten years nominal spending on social security and welfare has increased by over 150 percent, as has spending on health, while that on education increased by almost 180 percent. These rates of growth were at least one and a half times higher than that recorded for total government spending, and were substantially faster than the rate of GDP growth. As a consequence, aggregate spending in these social areas increased sharply from 20.4 in 1984/85 to 24.2 percent of GDP in 1994/95.

Although it is commonly believed that spending on the welfare state has been cut, the true position is that growth in spending in many other areas was slower and taxes were increased to fund additional spending. The additional spending has not, however, overcome poor performance incentives, particularly in the education and health sectors, which account for much of the public dissatisfaction with these services.

For its part, the Labour government massively increased spending on the welfare state. It rose from 20.4 to 26.5 percent of GDP between 1984/85 and 1990/91, an increase of 6.1 percentage points. The National government subsequently reversed this trend by 2.3 percentage points. Nevertheless, the ratio of welfare spending to GDP is much higher today than it was in 1984/85.

How has this increased expenditure been financed?

The answer is by a very large increase in government revenue. Total revenue has increased strongly from 31.6 to 38.2 percent of GDP in the past ten years. In dollar terms total revenue has increased by $20.8 billion or 166 percent. Of this amount, $15.3 billion has been used to finance new expenditure. A further $5.1 billion went towards an improvement in the operating balance. Almost all the improvement in the amount of the operating balance was achieved by the National government. However, for every $4 of additional revenue raised, $3 was allocated to fund new spending and only $1 dollar was used to improve the operating balance and, more recently, to pay off debt.

This analysis clearly shows that the improvement in the fiscal position has not been built on the backs of welfare beneficiaries. Since 1984/85 savings from lower benefit expenditure have been more than offset by higher spending on other components of welfare. The improvement in the operating balance mainly arises from higher tax revenues. Increases in indirect taxes, notably GST, made the largest percentage contribution to the growth in revenue. Company tax, which has increased by $2.8 billion, made the next largest percentage contribution, and indeed the largest in the period since 1990/91. So much for the Council of Trades Union's claim that businesses and their owners were not paying tax. These increases reflect the upturn in the economy and a broadening of the tax base.

However, for New Zealand to become a really dynamic, fast growing economy, the level of government spending, and therefore taxes, is still too high. Several arguments support this view:

- taxes that are required to fund government expenditure impose costs on the community because they distort the incentives to work, invest and save, and they bias many choices that firms and individuals make. Over recent years there has been growing support among reputable researchers for the view that big government substantially impedes growth;

- there are many government expenditure programmes of dubious quality. Poorly designed welfare programmes, for example, often discourage individual initiative and responsibility; and

- before the 1970s, when the economy performed better, government expenditure typically averaged around 20-25 percent of GDP. In the dynamic countries of East Asia, government expenditure is usually under 20 percent of GDP.

The latest budget revealed a slackening in efforts to contain spending. Government spending in this financial year and next is forecast to be about $700 million higher than in last year's budget, despite a reduction in unemployment benefits. There have been few efforts to cut spending programmes which are not cost effective. It was also disappointing that the latest budget gave no indications of plans for further privatisation. The transfer of government-owned commercial undertakings to the private sector in New Zealand and in many other countries has brought huge improvements in efficiency and helped to repay debt. There is much more we should be doing in this area at both central and local government levels.

Labour's recently released alternative budget proposes massive new spending over the next three years, amounting to at least $6.2 billion. According to Labour's latest projections, its proposals would lift the ratio of expenses to GDP to 35.7 percent by 1997/98. Most of the additional expenditure relates to social security and welfare, health and education. At least $1 billion would be spent on tertiary education which, as the Todd Taskforce reported, mainly benefits people from better-off families who will later earn above-average incomes.

Labour is proposing to spend more on activities that have grown rapidly since 1984. By 1997/98, annual spending on social security and welfare, health and education would be $2 billion or over 9 percent higher than forecast for that year in the government's latest budget. This contrasts with Labour's October 1993 assessment of its election promises which projected the ratio of spending to GDP to be lower than National's forecast in every year from 1994/95 through to 2000/01. In 1993 Labour committed itself to spending in 1997/98 which amounted to a forecast 31.8 percent of GDP compared with 35.7 percent in the alternative budget tabled this year. What could possibly justify such a large change in spending, especially as the economic outlook has improved since 1993? Opposition parties should be held to their pre-election commitments as much as governments.

The level of government spending is the best indicator of the tax burden. The present government plans to reduce spending from around 35 percent of GDP to below 30 percent. If this objective is achieved, and provided there are no unexpected economic developments, tax reductions will be possible once debt is reduced to an appropriate level. Total revenue was equal to 38.2 percent of GDP in 1994/95. Thus tax cuts amounting to around $7 billion would be possible in due course, which would represent an average reduction in all taxes of up to 23 percent.

Labour's latest shadow budget did not discuss possible tax cuts, although $2.4 billion was provided as a contingency provision. Additional taxes are to be imposed on taxpayers who earn more than $60,000 a year. If Labour were to increase expenditure to 35.7 percent of GDP as announced, there would be little scope for tax cuts and any such cuts would need to be deferred if debt were to be reduced to the prudent levels targeted by National. Labour's alternative budget implies that the tax burden will in future be up to 19 percent higher than under National.

There can be no doubt that tax cuts would make a valuable contribution to the growth of the economy. They would benefit all businesses and increase individual choice. However, the government will need to examine carefully how to structure the cuts. The broad principle should be to obtain the largest possible gain in efficiency while satisfying valid equity objectives. From an efficiency perspective, the highest effective tax rates, which include those faced by people on benefits entering the workforce, should be top priorities for reductions. However, the sums involved are such that all New Zealanders should benefit in due course.

The community will soon be facing some important choices. It needs to make them with a clear understanding of the benefits and the costs. Misleading claims by politicians need to be exposed and the business sector has a major stake in seeing that sound choices are made. I hope your Chamber will contribute to the public debate on the issues in pursuit of the best possible future outcomes for all New Zealanders.

Table 1
Change in Revenue, Expenses and Operating Balance
1984/85 to 1994/95

	1984/85	1994/95	Change	Change
	$m	$m	$m	%
Taxation				
Individuals	7,185	14,525	7,340	102
Company	1,113	3,875	2,762	248
GST/sales	1,561	6,836	5,275	338
Other	2,054	4,859	2,805	137
Total taxation	11,913	30,095	18,182	153
Other revenue	620	3,261	2,641	426
Total revenue	12,533	33,356	20,823	166
Net surplus SOEs and Crown entities		-455	-455	
Expenses				
Social security and welfare	4,458	11,438	6,980	157
Education	1,729	4,812	3,083	178
Health	1,911	4,889	2,978	156
Other functional expenses	4,572	5,906	1,334	29
Finance costs	2,563	3,658	1,095	43
Foreign exchange	-246	-405	-159	65
Total expenses	14,987	30,298	15,311	102
Operating Balance	-2,454	2,603	5,057	-206
	%	%	Percentage points	
Memorandum items:				
Total revenue: GDP	31.6	38.2	6.6	
Total expenses: GDP	37.8	34.7	-3.1	
Welfare expenses: GDP	20.4	24.2	3.8	
Balance: GDP	-6.2	3.0	9.2	

Table 2
Change in Revenue, Expenses and Operating Balance
1984/85 to 1990/91

	1984/85	1990/91	Change	Change
	$m	$m	$m	%
Taxation				
Individuals	7,185	12,692	5,507	77
Company	1,113	1,762	649	58
GST/sales	1,561	6,163	4,602	295
Other	2,054	5,180	3,126	152
Total taxation	11,913	25,797	13,884	117
Other revenue	620	1,943	1,323	213
Total revenue	12,533	27,740	15,207	121
Net surplus SOEs and Crown entities				
Expenses				
Social security and welfare	4,458	11,005	6,548	147
Education	1,729	4,401	2,672	155
Health	1,911	3,986	2,075	109
Other functional expenses	4,572	6,283	1,712	37
Finance costs	2,563	4,624	2,061	80
Foreign exchange	-246	-217	29	-12
Total expenses	14,987	30,082	15,096	101
Operating balance	-2,454	-2,342	111	-5
	%	%	Percentage points	
Memorandum items:				
Total revenue: GDP	31.6	37.9	6.3	
Total expenses: GDP	37.8	41.1	3.3	
Welfare expenses: GDP	20.4	26.5	6.1	
Balance: GDP	-6.2	-3.2	3.0	

Table 3
Change in Revenue, Expenses and Operating Balance
1990/91 to 1994/95

	1990/91	1994/95	Change	Change
	$m	$m	$m	%
Taxation				
Individuals	12,692	14,525	1,833	14
Company	1,762	3,875	2,113	20
GST	6,163	6,836	673	11
Other	5,180	4,859	-321	-6
Total taxation	25,797	30,095	4,298	14
Other revenue	1,943	3,261	1,318	68
Total revenue	27,740	33,356	5,616	20
Net surplus SOEs and Crown entities		-455	-455	
Expenses				
Social security and welfare	11,005	11,438	433	4
Education	4,401	4,812	411	9
Health	3,986	4,889	903	23
Other functional expenses	6,283	5,906	-377	-6
Finance costs	4,624	3,658	-966	-21
Foreign exchange	-217	-405	-188	87
Total expenses	30,082	30,298	216	1
Operating balance	-2,342	2,603	4,945	-211
	%	%	Percentage points	
Memorandum items:				
Total revenue: GDP	37.9	38.2	1.5	
Total expenses: GDP	41.1	34.7	-6.4	
Welfare expenses: GDP	26.5	24.2	-2.3	
Balance: GDP	-3.2	-3.0	0.2	

NEW ZEALAND LOCAL GOVERNMENT ASSOCIATION
ANNUAL CONFERENCE

THE BUSINESS OF LOCAL GOVERNMENT

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

NELSON
11 JULY 1995

THE BUSINESS OF LOCAL GOVERNMENT

Defining the Proper Role of Government

The topic we are addressing is: "Is there a proper role for local government?" The obvious answer is an unequivocal 'yes'. I am not aware of any reputable observer who would argue otherwise.

The idea that governments have an important role is neither novel nor controversial. It is also readily apparent that some government functions are better undertaken by local rather than central government. One or more sub-national levels of government are common in most countries.

A somewhat more relevant question is: "What is the proper role of governments at all levels?" The straightforward answer is that governments should undertake those roles to which they are best suited and leave others to the private sector. There is substantial agreement among public policy analysts on the principles that should determine when the government has a comparative advantage compared with the private sector.

The starting point of the standard analysis is that the overriding goal of individuals is to improve their welfare to the maximum extent possible. This encompasses the satisfaction of material wants, and also includes non-material wants, such as increased leisure and a higher appreciation of arts and culture. The objective of the government should be to provide the maximum scope for members of the community to achieve their goals.

- *Defining Property Rights*

The first fundamental role of the government in relation to this overriding objective is to define property rights appropriately. The system of property rights comprises all the limitations, constraints or rules which govern the way people in society live, compete and interact. This is a very broad definition which extends well beyond the rights of land owners. Common assault can, for example, be viewed as an infringement of the victim's property rights. The system of property rights affects the incentives for individuals and firms to make the best use of resources.

Property rights are costly to define and enforce. For this reason, they are seldom fully specified. The extent to which the owner's rights to use a resource, to extract income from it and to sell it are specified will depend on the costs involved. Nevertheless, the more precisely property rights are defined, the less the uncertainty faced by their owners and the lower the transaction costs of determining how resources may be used. Provided the attributes of property rights are adequately defined, they can be modified by voluntary negotiation.

While many property rights are defined by central government, local government plays an important part, particularly in administering the Resource Management Act. The adoption of district plans that alter the rights of home owners to subdivide their property is an example. There is substantial scope to improve the definition and enforcement of property rights. This would facilitate voluntary transactions which, by definition, do not occur unless all parties to them are better off.

- *Reducing Transaction Costs*

The second role of the government is to facilitate the provision of goods and services where private provision is impeded by high transaction costs and where the benefits of government action outweigh the costs involved. Excessive transaction costs could arise in respect of public goods, monopoly and natural monopoly, and externalities. Transaction costs should be kept as low as possible. However, they are pervasive and are too costly to eliminate completely.

A 1988 Officials' report on local government suggested that local government should focus on the provision of local public goods. It is widely accepted that pure public goods have two properties. First, it is impossible to exclude individuals who do not contribute to the cost of their production from enjoying their benefits. This is known as the non-excludability property. Each person has an incentive to wait for someone else to provide the goods, leading to a free-rider problem.

The second property of pure public goods is that it may be undesirable to exclude individuals from the benefits of the goods because the enjoyment of them by one person does not detract from that of other people (the non-rivalrous property). National defence and street lighting are commonly cited as examples of goods that come close to satisfying both characteristics of pure public goods.

According to the traditional view of pure public goods, if their provision were left to the private sector in an otherwise unconstrained market they would be supplied in inadequate quantities or not supplied at all. Public provision of such goods or other government action would appear to be required.

This view of public goods has been reassessed because the non-excludability and non-rivalrous properties reflect transaction costs. Non-excludability becomes a problem if the costs of identifying those who benefit from a particular activity are prohibitive. For example, with present technology it is likely to be excessively costly to charge motorists directly for the use of every road, although the use of tolls indicates that this is not always the case.

The problem that arises in respect of the provision of public goods may be overstated. Pure public goods are extremely rare. The extent to which goods and services exhibit the features of public goods differs from product to product and, for given goods, through time. Technological change may, for example, affect the extent to which goods and services approximate pure public goods. The development of cable television and the scrambling of television signals have now made it feasible to exclude non-subscribers from certain broadcasts.

The approach of tying the fee for a particular service to the charge for another is another possible solution to the non-excludability problem. The funding of roading through petrol taxes is an example. Electronic tolling may make direct charging for road use feasible in the future.

Natural monopoly is another area where government action might be justified. Natural monopoly exists if one firm can supply the output of an entire industry at a lower cost than two or more independent firms. A natural monopoly can set its prices above marginal cost. However, provided the firm faces at least potential competition, for example where the right to supply is subject to tender, the industry faces similar incentives to a decreasing cost industry with more than one producer.

New entrants into an industry may be discouraged where high sunk costs (i.e. costs that are not recoverable if the firm leaves the industry) enable the existing producer to lower prices to reflect incremental operating costs only. Significant sunk costs afford a producer a degree of monopoly power.

A number of local government services are often said to constitute natural monopolies involving high sunk costs, for example water, sewage, drainage and roading systems. The demand and supply conditions of the particular industry, including the state of technology, are important in assessing whether to view an industry as a natural monopoly.

Traditionally, governments have engaged in production where competition is restricted, or they have subjected private producers to industry-specific regulation. A contemporary analysis, recognising the weak incentives for efficiency that governments face as well as the importance of transaction costs, cautions against a heavy-handed approach. Furthermore, where government action is justified, there would be strong grounds for facilitating competition in the supply of services, for example through competitive franchising.

Another possible rational for government action relates to the presence of significant externalities. A positive (negative) externality arises whenever an action by a firm or an individual increases (reduces) the welfare of another. A positive externality arises, for example, because a neighbour's garden provides enjoyment to others. From the community's point of view, externalities may result in the wrong levels of production because decisions to produce will reflect private rather than community-wide benefits. While subsidisation of the producer may appear to be warranted by positive externalities, it is also desirable to impose the cost of such subsidies on people benefiting from the externality. The opposite situation applies in respect of negative externalities.

Most activities produce externalities and most do not justify government action. The issue for public policy is whether the benefit of government action aimed at addressing externalities is likely to outweigh the costs involved. Even if an externality provides valid grounds for government action, the government would need to choose the best instrument to address the problem (for example regulation or public funding).

Externality grounds are the apparent rationale for some local regulation (for example controls on noise, and certain fire safety and building regulations). Some local authorities subsidise major sporting and cultural activities, libraries, art galleries and some city or town promotions in the belief that they provide wider benefits for the local community. There are, however, grounds for questioning the efficacy of some of this expenditure. Private sector promoters are able to capture many of the benefits that arise from major sporting and cultural activities. They may, for instance, obtain sponsorship from key beneficiaries such as airlines and hotels. Local authorities often impose the costs of their support on ratepayers rather than on the beneficiaries.

- *Regulation*

The third role of the government is to act as a regulator. This role relates to the previous two and could possibly be considered to be fully encompassed by them. The establishment of property rights and procedures for their enforcement involves regulation. So may the role of reducing transaction costs to an efficient level. Regulation may, for example, be an alternative to public provision of goods and services where competition is limited.

Regulation may be required to help decide between competing rights because property rights are not fully defined. The right of a factory owner to discharge wastes into the atmosphere may, for instance, need to be balanced against the right of affected people and firms to clean air. Some regulation of building standards may be justified because it would be too costly for the public to assess whether the buildings that they frequent provide at least a minimum standard of safety. Externalities may arise if a fire extends from one property to another. Building regulations may be aimed at reducing these costs and associated risks.

The costs and benefits of regulatory proposals need to be carefully examined. In some instances the overall harm produced by a regulation may be greater than the mischief that led to it. In addition, perceived problems may be better addressed by modifying or clarifying property rights, or by introducing subsidies or taxes. Thus the full set of options available to local government, including the option of taking no action, should be considered and the best chosen.

- *Provision of a Safety Net*

Finally, the government has a role to provide a safety net for people who are unable to support themselves. This role, and the funding of health and education to ensure people have proper levels of access, rests with central government in the New Zealand context.

Division of Roles Between Local and Central Government

In the discussion to this point, I have suggested the following:

- that the role of the government should be to facilitate improvements to the welfare of the community that elects it; and

- that the main roles of government are:

    - to define property rights appropriately. Property rights establish the framework within which individuals and firms interact and compete. They affect incentives for firms and individuals to make the best use of resources;

    - to facilitate the provision of goods and services where private provision is impeded by high transaction costs and where the benefits of government action outweigh the costs involved;

    - to act as a regulator. The establishment and enforcement of property rights and the reduction of transaction costs to an efficient level may require regulation. Regulation may, for example, be an alternative to public provision of goods and services where competition is limited; and

    - to provide a safety net.

With the exception of the last role, the roles of central and local government are essentially the same. Local government is poorly equipped to address income distribution and equity issues because it does not have access to adequate information or appropriate mechanisms to assess and deliver assistance effectively.

The division of responsibilities between central and local government should be decided on the basis of which level of government is best placed to undertake the required task. The main factors that are relevant in making this judgment are twofold:

- relevant knowledge: the effectiveness of some government activities depends on local knowledge. This may be particularly relevant for day to day administration of regulation. Central government may not possess local knowledge to the same extent as regional or territorial authorities, mainly because of its focus on national issues; and

- appropriate incentives and accountability: it is desirable for activities to be organised and funded by local government where it is appropriate for politicians to be accountable to local rather than national electorates. This is especially the case where a balance is required to be struck between competing local interests such as the benefits and costs of local services. On the other hand, local representatives may give inadequate attention to national interests. In this case, there are grounds for issues of national importance to be decided by elected representatives who are accountable to national electorates.

Local Sovereignty

Under New Zealand's constitutional arrangements, parliament is sovereign. The powers of local government are delegated by parliament. Central government therefore sets the rules within which local government must operate. Present arrangements provide local government with considerable scope to choose what activities it will undertake.

The question that councils must address is what principles should determine their choices. The LGA's background paper for this conference briefly discusses this issue but its treatment seems confused. In particular it appears to be attacking a straw man when it asks the question: "[S]hould councils be able to apply their reasoned discretions in deciding what balances of service deliveries and funding should be achieved, according simply to local choice and local preferences?".

My answer to that question is a clear 'yes'. Councils should be free, as a matter of law, to decide what activities they wish to undertake and central government should not tightly constrain their decisions. But that is very different from saying that, as a matter of practice and good government, it makes sense for councils to engage in activities willy nilly. A council should, for instance, be legally able to produce food and run restaurants, and raise rates for the purpose if it wishes. But how many people would think that these would be sensible activities for a council to undertake? If the answer to that question is none, or few, it establishes that most people think that there is some kind of proper role for local government. The issue then is how to define it. My argument is that the principles outlined earlier should be rigorously applied to each activity to establish whether it conforms clearly with them.

The Core Activities of Local Government

Following the principles suggested in this paper, the core activities of local government are likely to include local roading, water and sewage, certain civic amenities and democratic processes where public good issues arise. The administration of health and safety, resource management and other regulatory functions delegated by central government also conform with the suggested principles.

Some councils engage in activities that cannot be justified on this basis. They involve the provision of private goods and services, for example the ownership and operation of ports, airports, power companies, parking buildings and involvement in commercial property development. These are better undertaken in the private sector where more appropriate incentives for efficient performance apply. Commercial activities should not be retained to help finance core activities. These are more appropriately financed by user charges and rates.

District councils occasionally provide programmes aimed at the promotion of business development, tourism and employment. These programmes are also generally inappropriate. The subsidisation of one business requires a tax to be imposed on another. The efficacy of most employment programmes is doubtful for similar reasons. Their costs fall directly or indirectly on other employers and thereby impair employment elsewhere.

The current extent of political decision making in the provision of infrastructure seems likely to pose a threat to sustained economic growth. The largest problems in expanding infrastructure, such as schools, some energy supplies, roading and water and sewage systems, are appearing where the public sector is primarily responsible for its provision. This contrasts with parts of the economy that are deregulated and subject to full commercial disciplines. No serious problems seem likely to arise in respect of infrastructure such as telecommunications and transport, other than roading, which are private sector activities.

Structural reform of bulk water supply is an important task now being addressed in many countries. There are a large number of potential ways to secure efficiency improvements. These include metering, better contracts with customers, improved infrastructural management, integration of bulk and retail supply, regulatory reform, franchising, corporatisation and privatisation. New Zealand is lagging well behind many countries in water industry reform.

Privatisation is only one aspect of the issue but it deserves serious examination. The flat rejection of the idea by some local body politicians, such as the chairman of the Wellington Regional Council who has been outspoken on the subject, can only be based on ideological grounds. Councils are not serving their constituents well if they are not examining all options in a pragmatic way and exposing their analysis to public scrutiny. Major efficiency gains have resulted from structural reform, corporatisation and privatisation in other industries that were previously owned by the government. It is entirely appropriate to examine whether similar policies in relation to water supply, roading and other infrastructural industries might provide comparable benefits.

Is Local Government Adopting its Proper Role?

There have been some impressive changes within local government over the past few years. Commenting on the analysis of local government issues which our organisation has put forward, a chief executive of a district council recently wrote:

> I really can't take issue with too much of what you have to say ... . You may be interested to know that our approach ... is to stick to what we believe to be local government's core business - roading, water, sewage, stormwater, some recreation and civic amenities, and district planning.

The steps that have been taken by this council to reshape its business include the contracting out of services, complete withdrawal from refuse collection, metering of water supplies, the sale of its interests in electricity supply and the application of user charges to fund most planning and water reticulation activities. Furthermore, the council's plan includes the consideration of "options for the future ownership and management of sewage and water supply assets" among its objectives for the current year.

Other councils have made similar comments to us and extended specific invitations to submit comments on their annual plans. This illustrates an openness to debate that was not previously present in local government.

So far in our work we have reviewed the annual plans of the Auckland, Christchurch, Dunedin and Wellington cities, and the Wellington Regional Council, for up to three years. We have also analysed a range of other plans and discussion papers released by local authorities. Our assessment is that, generally speaking, the greatest progress is occurring in the smaller local authorities and that, with the exception of Dunedin City, the main cities lack a clear focus on their core tasks, although Wellington City is improving. Christchurch City seems particularly confused over the proper roles of the private and public sectors.

The main cities are still involved in many businesses which, in our view, they should exit to the benefit of their communities. The case for privatisation and other asset sales rests on the overwhelming evidence that private ownership is usually more efficient than public ownership. Privatisation is a general policy of many governments of all persuasions around the world. The comment in the LGA's background paper that privatisation is a "right-wing" policy is simply nonsense. As *The Economist* recently observed, commenting on the British Labour party's recent abandonment of its commitment to state ownership:

> This week marks no turning point in the party's thinking on economic policy: it merely formalises a recognition by the British left, achieved over the past few decades, that state ownership secures the fruits of industry for nobody.

Elected representatives have a duty to provide quality leadership. They should examine difficult issues objectively, take account of professional analysis and advice and promote informed debate so that decisions are taken which are in the best interests of the community.

Conclusion

The thrust of my remarks is that there is a proper role for local government. It is a positive one but it is not open-ended. Subject to New Zealand's constitutional arrangements, it should not be laid down by fiat by central government. Local sovereignty is appropriate. However, good government depends on careful observation of proper principles defining the boundaries between the local public and private sectors. These should be the subject of democratic debate, recognising that if the boundaries are overstepped, community well-being is likely to suffer.

Economics and public policy analysis provide guidance on the most effective roles national and local governments can play in the economy. The strong thrust of thinking worldwide is towards less intervention. The most constructive contribution that each local government can make to its economy is to restrict its activities to those that should properly be undertaken by local government and to perform them efficiently. This would enable councils to reduce expenditure, rates and regulation, and make their districts and regions more attractive to households and firms as places to live, work and do business.

AMP POST BUDGET FORUM

A BUSINESS PERSPECTIVE ON THE 1995 BUDGET

ROGER KERR
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NEW ZEALAND BUSINESS ROUNDTABLE

WELLINGTON
2 JUNE 1995

A BUSINESS PERSPECTIVE ON THE 1995 BUDGET

One way of looking at the budget is to see it as a statement on the government's financial accounts. One way of commenting on it, therefore, is to draw up a list of credits and debits. Let me start with the credits, which, if I remember my accounting studies correctly, go on the side by the window.

My first entry goes to the minister of finance. I believe the business sector has seen Mr Birch as a minister with a safe and steady pair of hands, and he didn't disappoint us last night. In two budgets now, he has maintained the hard-won reputation for fiscal credibility and predictability established by his predecessor.

A second credit goes to the government, including the caucus, for backing the post-1991 programme of fiscal discipline. It has been a major factor in New Zealand's economic turnaround, and all the social benefits that are now flowing from it. We all know how easy it is for politicians to succumb to pressure to spend someone else's money, and to pass the debts on to the next generation. We must pay a tribute to the whole government caucus for putting a stop to what Ruth Richardson used to call fiscal child abuse.

Coming to the fiscal trends outlined in the budget, it has to be said that the progress made by the government since 1991 is impressive by any standards. The key gains are, of course:

- a reduction in government spending from over 41 percent of GDP in 1990/91 to around 35 percent this year;

- the turnaround from a large operating deficit to a large operating surplus;

- falling debt levels which are taking New Zealand out of the danger zone; and

- the achievement of a positive level of net worth in the Crown's balance sheet. In the coming financial year New Zealand Incorporated will no longer be insolvent.

The next credit is the latitude that is opening up for tax reductions. Provided expenses are held and the government continues to reduce the share of national income that it spends, there will be scope for a multi-year programme of sustainable tax reductions. This will boost growth in production and jobs. High tax burdens in today's world mark one of the key differences between the sluggish economies of Europe and the dynamic economies of East Asia.

In passing it is worth noting that debt and taxes are closely related. Just as higher debt means higher future taxes to repay the loans, lower debt means lower future taxes. The benefits of lower debt accrue now, as they are anticipated by financial markets.

We can also enter as a credit, I believe, the general preconditions and parameters of the tax reduction programme outlined by the government. The basic approach to tax reductions should be similar to the approach taken to tariffs - a medium-term programme concentrating on reductions to the 'tall poppies'. These are where the so-called 'deadweight losses' or economic costs of taxation - the drag on growth - are greatest. In this context, the 'tall poppies' are essentially the high effective marginal tax rates, which include the rates faced by beneficiaries moving into the workforce as benefits abate. Also in the 'tall poppy' category are high personal and company income taxes, taxes on international income, and excises. We should continue the moves towards a broad-based tax system with low, uniform rates.

One of the specific measures worth singling out as a credit is the emphasis that the government is putting on the private sector in education. The increased funding to independent schools is a step towards levelling the playing field, and the pilot scheme to allow parents of disadvantaged children to send their children to independent schools also expands parental choice. But why not take this approach a whole lot further and open up a choice of all schools to all parents? And regrettably, such progress is being undermined by the government's refusal to recognise some of the appalling developments in curriculum and qualifications policies which are devaluing the content of much of what is taught in schools.

A final entry on the credit side of the ledger is the introduction of inflation-indexed government debt. It will provide another discipline on governments as the inflationary spread between indexed and nominal debt is revealed in the market.

I turn now to the debit side of the ledger. This list is shorter but the items are very significant.

My first entry has to be the large increase of around $700 million in government spending now projected for this financial year and next, compared with the forecasts in last year's budget. I don't think anybody would want to argue that none of the benefits of the improvement in the economy should go towards public sector programmes. But we should note:

- first, that the large sums being saved on debt servicing and unemployment benefits are being more than offset by new discretionary spending;

- second, that some of this spending appears to be of dubious quality; many of the problems in health and education, I suggest, are not due to a lack of resources overall but to the weaknesses in the structures and incentives of the systems; and

- third, there seem to have been few efforts to cut back government spending programmes which are not cost effective.

The second debit entry is the disappointing lack of indications of plans for privatisation. The transfer of commercial undertakings to the private sector has brought huge improvements in efficiency and helped repay debt. Recently NZ Rail indicated that its productivity levels had improved by 35 percent since it was privatised two years ago, one third of the total gains of the last twelve years. In Wellington the privatised bus company Stagecoach has cut fares in real terms by 10 percent since 1991, the subsidy requirement has been cut by $9 million a year, and it is boosting passenger numbers by 300,000 annually.

It is therefore mystifying that the government, and particularly the minister for state-owned enterprises, has not been actively communicating these kind of stories and addressing the negative sentiment that still persists about privatisation. Taupo District Council announced this week that it would privatise its electricity interests, and it is to be hoped that the government does not keep electricity in the too-hard basket in the medium term. An overwhelming proportion of the electricity industry around the world is now private. The benefits of more processing and value-adding in forestry, more innovation in postal services, more technological advances and international linkages in television and so forth, would all be enhanced by privatisation.

Finally, we can also look at the budget not only as an accounting statement but also as a statement of the government's vision and strategy for the future. Here we find both credits and debits to record. On the one hand, the government remains committed to its 'Path to 2010' goal of annual economic growth in the 3.5 - 5 percent range. Many of the reforms that are in place or still in train will contribute to that goal. The benefits of lower tax rates in the future, tariff reductions and the increasing pension age, for example, are still to work through. Moreover, we should not look only to the government for improvements in economic performance. A large share of the responsibility lies with the private sector to fully internationalise, upgrade management and enterprise skills and reach world class benchmarks of performance.

Nevertheless, the average growth rate of 3.5 percent projected for the next two years is not particularly inspiring. It is well below what the fast-growing economic reformers are achieving. We should not be content with under-achievement in economic and social policy when higher standards of achievement are possible. Such aspirations have been called "too ambitious" but we have seen that ambitious goals can be achieved. Apart from a few so-called extremists, who would have believed a scenario five years ago of large, sustained budget surpluses, a rapid paydown of net debt, net overseas debt headed to zero, a bond tender programme scheduled to disappear over the next two years, and huge tax cuts of perhaps over $6 billion between now and the end of the decade?

People who are still struggling will not be helped by inertia. Under-achievement involves costs, such as lower living standards, higher unemployment, and poorer health and education services than we could enjoy. Those with a bolder vision - politicians and all - need to spell out the benefits of continuous economic improvement. Bad economics, a contentment with the status quo, a vision of leaving New Zealand no worse than it was before, must not be allowed to become good politics again. Sir Robert Muldoon did not set out to become the world's worst finance minister, but years of timid gradualism earned him that dubious honour.

Progress will not occur unless the community understands why and how we could do better. The private sector must share the task of promoting a consensus for change that would build on the reforms to date. There is still a need to respond much more effectively, for example, to claims that sound fiscal policies are only intended to please financial markets and do nothing to help ordinary people. In the final analysis, financial markets simply reflect the long-term prospects of higher incomes in any economy: if there are no such prospects to reflect, it is bad news for the community as a whole.

Similarly, the claims we heard again last night that the benefits of growth are not being widely shared must be addressed and rebutted. Since the economic framework became broadly coherent in 1991, fiscal and monetary discipline has dramatically lowered interest rates on home mortgages, around 150,000 jobs have been created thanks in large part to the Employment Contracts Act, wages are projected to grow in the budget by 3 percent per annum in each of the next three years after 25 years of stagnation in real earnings, the prices of goods and services to consumers are not expected on average to rise at all next year, the costs of artificially inflated consumption standards are not being passed on to our children to repay and, for those who equate social benefits with more public spending on health and education, the government has had the means to substantially increase outlays. Assertions that the country is not getting a social dividend simply do not stand up to scrutiny. Growth and flexible labour markets are far stronger forces for lifting all boats than any amount of income redistribution.

I won't attempt to add up my entries and calculate a bottom line. After years of the equivalent of red ink, both the budget and New Zealand's economic standing are now in the black. This is a tremendous achievement. It is the legacy of those who had the vision to initiate the reforms in 1984 and extend them in scope and depth through an immensely difficult period. But the job is not completed or, more accurately, it never will be. In our business firms today we must continuously take stock, review everything, and strive to find ways to do better. The job of economic management is no different.

The minister referred to the America's Cup in his speech last night. We know we won't retain it by resting on our 1995 laurels. The government has a goal of restoring New Zealand's triple A credit rating. It won't achieve that by resting on its 1995 laurels either. We must hope that the community is developing the same expectations of our political representatives as it has of our sporting representatives, and will back them to go for the top prizes in both sporting and economic achievement.

JOHNSONVILLE BUSINESS ASSOCIATION

LOCAL GOVERNMENT: THE FORWARD AGENDA

ROGER KERR
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NEW ZEALAND BUSINESS ROUNDTABLE

JOHNSONVILLE
9 MAY 1995

LOCAL GOVERNMENT: THE FORWARD AGENDA

Why is local government important?

Local government has been of increasing interest to the New Zealand Business Roundtable for two main reasons. First, local government is an important sector of the economy. It accounts for over 3 percent of GDP and employs about 36,800 people. In terms of income, expenditure and assets, many councils rank with New Zealand's largest enterprises. The Wellington City Council, for instance, plans to spend $160 million in 1995/96. It has assets of $2 billion, which is equal to almost 4 percent of the aggregate assets of the top 40 non-financial corporations listed on the stock exchange.

In addition to the delivery of services, local governments frame or administer many bylaws or regulations that affect community welfare. Regional councils are primarily regulatory agencies.

Local authorities are subject to relatively weak monitoring arrangements, which can lead to a divergence between the interests of the principals (ratepayers) and their agents (councils). Pressures for excessive spending can arise where the benefits of services are highly concentrated amongst a few ratepayers but the costs are spread thinly over a diffuse majority.

Unless local government spends and regulates wisely, national output, income and employment will be lower than otherwise. An important reason for examining local government is, therefore, to assess whether it is making the best possible contribution to the economy.

The business sector has a specific interest in local government because its activities affect every business in the country. Local government currently provides many services such as local roading, water reticulation, storm water and sewage disposal that are essential to businesses as well as residents. Its regulatory activities affect many decisions including the establishment of projects that require resource consents, the location of businesses, the design of buildings, and work practices such as the handling of food.

For many businesses, local authority rates are a significant cost. The mayoral taskforce on commercial rates found that Wellington City imposes the highest annual rate per capita ($728) of the ten major cities surveyed. In addition, an excessive proportion of its rates is borne by businesses. A separate study showed that rates payable by four middle to top class Wellington hotels amounted to between $1,820 and $3,430 a room. The most heavily taxed hotel would need to let each room at its standard rate for 18 nights just to meet its annual rates bill. Such taxes discourage tourism, investment and employment. They swamp the positive effects (if any) of programmes aimed at attracting major events to the city.

Les Mills, the mayor of Auckland City, recently reflected the public's scepticism that local authorities provide good value for ratepayers' dollars. He said:

> The thing that everyone is sick of is having money taken out of their pockets by politicians who think they can spend it better.

It is interesting to note that the real income before tax of a worker with a dependent wife and two children earning the average wage increased by about 20 percent in the thirty years to the mid-1990s. However, after tax and net of cash benefits, the result for the average worker was a slight reduction in real income. What happened was that all the growth in real per capita incomes went to increased services supplied by the public sector.

A start has been made in cutting back public spending from the peak reached in the early 1990s. However, public expenditure broadly defined (that is, including that funded by compulsory levies and fees such as ACC and the fire service) still amounts to at least 40 percent of GDP. This is more than double the equivalent percentage for successful Asian countries.

The proper role of local government

In January this year, the Business Roundtable published a report entitled *Local Government in New Zealand*. It noted that considerable changes have been implemented since 1987 when the latest phase of local government reform began. The functions of regional and territorial authorities have been clarified and the sector has been substantially reorganised. Most special purpose authorities have been absorbed by territorial and regional councils, while territorial authorities have been expanded by amalgamation. A few local government trading activities have been sold and some have been corporatised. In addition, port, airport, transport and energy companies have been established under specific legislation.

Local government has been encouraged to become more efficient. Some business activities undertaken by local authorities have been subjected to commercial disciplines to a greater extent than previously, with gains in operating efficiencies. Local authorities have contracted with the private sector for the supply of some services that they previously produced themselves. Public transport, road construction and maintenance, refuse collection, park maintenance and regulatory activities have been affected by these developments. Large savings have been achieved in many cases.

There is, however, substantial room for further improvement in the efficiency of local government. As New Zealand moved away from being an outward-looking market economy during the century up to 1984, local government became increasingly involved in activities of a private rather than a public nature. The process of reversing that wealth-destroying trend has only begun. Most councils, particularly larger city councils, have not undertaken a sufficiently rigorous examination of their proper role. They appear to lack a clear view of the appropriate demarcation between the public and private sectors. Wellington City, for example, stated that it would undertake a thorough review of its role in 1993/94 but it has not yet done so. This is now one option that has been put forward in the draft 1995/96 plan.

Many activities that local governments perform cannot be justified in terms of standard criteria for government intervention in the economy. Where government action is desirable, its current form is often inappropriate. Local authorities continue to hold interests in a large number of commercial enterprises such as off-street parking, airports, energy supply, rental housing, refuse collection and disposal, commercial property development, ports and transport operations.

Auckland City, for instance, is currently planning a property development of 'Think Big' proportions. Wellington City intends to increase its investment in off-street parking. Christchurch City seems the most confused of all about the proper roles of the public and private sectors. It is heavily involved in business activities in the mistaken belief that revenues from them are necessary to fund other services. Through its shareholding in Southpower which has bought into Enerco, Christchurch City is on a path to nationalisation not privatisation - an extraordinary move given worldwide trends since the 1980s.

There are no compelling grounds for local government to engage in business activities. There is substantial evidence that public ownership of commercial businesses is less efficient than private ownership. That is the reason why governments of all political persuasions are engaged in privatisation. Politicans should not be playing with ratepayers' money and taking risks on their behalf. Subject to the resolution of any outstanding regulatory issues, local government interests in commercial businesses and activities should be sold. A vigorous programme of privatisation and asset sales should now be an urgent priority for local government.

Infrastructure

Now that the economy is performing so strongly, thanks to the reforms of the last ten years, attention has turned to the task of sustaining growth and avoiding bottlenecks. In this context it has become fashionable to raise concerns about infrastructure. However, from an economic perspective there are no compelling grounds for regarding investment in infrastructure as being different from any other investment. There is no likelihood of significant shortages where infrastructure is supplied through private markets, for instance construction, telecommunications, transport and some forms of energy. The construction of the Auckland casino has taken place without the strains and disruption that were common in old New Zealand.

On the other hand, difficulties are being encountered where infrastructure is supplied by the public sector and where resource management regulation is creating investment uncertainty. Examples include roading, overcrowding at preferred schools, water shortages in Auckland, and the time taken by successive councils in Wellington to resolve the issue of sewage disposal. If we are not careful electricity supply will be added to this list in the next couple of years. These failures arise because public supply relies on political and administrative decision making which is costly, unresponsive and subject to interminable wrangling between political factions and interest groups. Market mechanisms for decision making, competitive pricing and commercial disciplines should be introduced into the provision of infrastructure wherever possible to avoid bottlenecks to growth.

The role of competition

Local government services are commonly subject to inadequate competition. Local authorities are often the sole suppliers of services or their output is highly subsidised, thereby discouraging private providers from competing. Competition, including a genuine threat of competition, is essential to focus suppliers on satisfying the needs of consumers, containing costs and innovating. How many private libraries do we now have lending popular books to the public? *City Voice* reported last year that a private tip in Happy Valley Road was likely to close because it could not compete with the subsidised council tip. How many potential businesses simply don't get off the ground because they can't compete with subsidised council services?

Where there are valid grounds for government intervention, local authorities should facilitate competition by contracting for a wide range of services. The right to supply core services such as roading, water supply and sewage reticulation could be subject to competitive tender on a regular basis. Services might be supplied under a franchise as is the case with reticulated gas. The local authority would arrange for the supply of services and monitor whether suppliers met their obligations.

There is also considerable scope to increase competition in the supply of regulatory services. The engagement of independent qualified persons to carry out certification functions under the Building Act is an example of the way in which the benefits of competition in this area can be obtained.

Over recent years, public policy in a number of countries has promoted competitive private participation in the provision of local government services. The community has benefited from improved services and lower costs. Corporatisation and privatisation of water supplies, for example, have been common developments in many countries.

Some local authority leaders like Stuart Macaskill, chairman of the Wellington Regional Council, adopted a head-in-the-sand attitude when we raised such possibilities for water supply earlier this year, dismissing them as "nonsense." He seemed unaware that communities like Oamaru and Waiheke Island obtain all their water from private sources, that Adelaide is planning to contract out its water supply and that the state of Victoria is engaged in a bold programme of water reforms. Any local authority not looking at metering, restructuring, corporatisation, franchise bidding and other options for improving water industry performance is neglecting its responsibilities.

User charges

An appropriate application of user charges can help foster competition and encourage a better use of resources. User charges require consumers to take the costs of services that they demand into account. This promotes conservation of resources such as water. User charges provide information to suppliers on the value consumers place on services. They help producers to decide the type and quantity of services that should be supplied. If user charges are not applied, less efficient allocation mechanisms, for instance rationing, are necessary to limit demand. Rates are also pushed up.

Most services provided by local government should be subject to direct user charges. The main exceptions are parks and reserves, certain recreation facilities where the costs of collecting user charges would be excessive, civil defence and democratic processes. These may be viewed as public goods in the economic sense of the term.

In many cases user charges are not applied, or are set at inadequate levels, for services such as water, sewage (for which charges can be tied to water use), libraries, art galleries, dedicated sport facilities and regulatory services. High subsidies for these activities are unlikely to be justified on efficiency or equity grounds.

A 1994 study by the Wellington City Council showed that each visit to the city art gallery and the maritime museum was subsidised at a rate of $20 and $8 respectively while each book borrowed from a local library was subsidised by $4. The Council's priorities survey showed that facilities such as the art gallery, council housing, parking enforcement and the zoo were of least importance to residents.

Another council reported that its community surveys showed that there was 80 percent support for part charges for services like the art gallery, the library and aquatic centres. It is clear from these surveys that the public does not believe that such services should be free or largely free to users, as some interest groups would have us believe.

Rating policy

Rates provide a financial base for local government that is independent of central government, relatively cheap to administer and capable of being adapted to suit local circumstances. If expenditure is kept to an appropriate level, rates are a satisfactory tax base for local government.

The distribution of total rates between business and residential ratepayers is inequitable in many cases, nowhere more so than in Wellington City. The present rate differential cannot be justified by any principle relating to the benefits of services supplied to businesses.

One rationale that has been advanced for differential rating is that rates are a tax deductible expense to businesses but not to households. This argument is simply wrong, as the mayoral taskforce pointed out. It reflects a misunderstanding of the way in which the tax system is designed.

Income earned by firms is generally subject to income tax. Because firms are taxed on a net rather than a gross basis, a deduction for expenditure on rates is permitted. Residents receive a deduction for rates if their gross income is taxed, for example where property is rented. However, where gross income, for instance the implicit rents that accrue in respect of owner occupied housing, is not taxed, a deduction for related costs including rates is disallowed. Owner occupiers are, if anything, relatively advantaged because they do not pay tax on the net income that arises from their investment in housing. It follows that firms do not gain an advantage over residents because they can deduct rates for tax purposes.

A related claim is that businesses are favoured because they can claim an input tax credit for GST paid in respect of rates. However, GST was designed to impose tax on final consumption spending. For this reason, firms (but not final consumers) generally receive a deduction for GST paid on inputs. This deduction is intended to avoid a cascade effect where the amount of tax is affected by the number of traders involved in the production and distribution of goods and services. Business firms, other than those supplying exempt services, pay GST on the net value that they add. The sum of net value added by each firm, together with the cost of imports (which are subject to GST at the border), equals the final selling price of goods and services. There is no concession for firms.

This myth about the preferred tax status of business should therefore be disposed of once and for all.

In Wellington City businesses bear 67 percent of the rate burden. The rate per dollar of rateable property levied on businesses, which is the best measure of the relative rate burden, is six times higher than that payable by residential ratepayers. Consider for a moment a simplified example involving a residential house on Tinakori Road. If the house is converted into a small shop with no change in its value, rates payable by the owner would rise six fold. Could this change in the property's use possibly suggest a six fold increase in the level of services demanded from the Council? Consider the same issue from the other side of the coin. If a shop is converted to a private residence, would the level of services required fall substantially? If there were a large reduction in the number of businesses, would the Council plan for a six fold reduction in its expenditure?

The mayoral taskforce examined the issue of the rates differential and came up with a sensible strategy involving:

- a reduction in total spending to reduce Wellington City's revenue requirements;

- a review of user charges with the objective of recovering the private costs of services provided which cannot be justified in terms of broader public benefits; and

- a progressive phase-down in the commercial/residential share of rates from 67:33 to 50:50 over five years. A further review would take place in four years' time.

The Council has included the phase-down suggestion as an option in its draft plan for 1995/96. However, its attractiveness to residents is reduced because an increase in residential rates is suggested rather than a reduction in Council expenditure as recommended by the taskforce.

Unjustified rate differentials reflect the voting strength of householders relative to businesses. It is up to the business sector to challenge unfair rating policies, if necessary through the courts.

Borrowing and financial management

The borrowing powers of local authorities have been under review since 1987. They are restrictive and most local authorities have avoided excessive debt. The Local Government Law Reform Bill provides for central government oversight of local authority borrowing to be replaced by a more modern borrowing regime. The Bill would also apply the principles of the Fiscal Responsibility Act to local authorities. The Business Roundtable has supported the thrust of the proposals in a submission on the Bill. We have also suggested that there is scope to upgrade the Bill by improving its monitoring provisions, requiring local authorities to set out clearer targets for net worth and debt levels and to establish a risk management strategy, introducing a credit rating requirement in the case of larger local authorities, and requiring a statement of the principles behind the activities engaged in by individual councils.

The financial management of local government has been significantly improved. Local authorities have responded positively to the changes, which contrasts with their resistance to earlier reform efforts. They are still adjusting to the changes that have been introduced since 1987 and the full effects of the reforms are not yet apparent. Nevertheless, there can be little doubt that greater transparency of local authority activities has facilitated monitoring by external parties and is increasing pressures on local authorities to improve their performance.

Recent reports by the Controller and Auditor-General suggest that there is considerable room for better financial management practices, particularly in respect of core services such as drainage, sewage and water supply, and in the management of trading activities. The development of performance indicators that meet the intent of the legislation has not yet been generally achieved. Some councils, such as Christchurch City, have made more progress than others, like Auckland City. The quality of annual plans has improved but still varies markedly.

Conclusion

Our report *Local Government in New Zealand* was generally well received. A number of council chief executives wrote to indicate that they agreed with most of it. One response suggested that local government was moving in the right direction and, measured against our conclusions, deserved a mark of about 7 out of 10.

An exception was the response of the Labour Opposition spokesperson on local government, Richard Northey, who "rejected the thrust" of the report. He opposed the arguments for privatisation, contracting out and user charging, despite the evidence of the benefits of such polices both in New Zealand and around the world. Expressing the view that local government is the best deliverer of most community services, Mr Northey added:

> Dunedin and many other councils have demonstrated that local government is usually the most effective organisation for co-ordinating and ensuring growth in their districts.

No evidence was advanced to support this assertion. If it were true, the community would be petitioning councils to supply basic necessities like food and clothing. This is not the case, as Les Mills correctly noted. It is nonsense to suggest that the Dunedin

City Council or any other council is the most effective organisation for ensuring regional growth. The prerequisites for growth are a sound national economic framework and a healthy, competitive business sector. The best contribution local government can make is to stick to a limited range of core activities and perform them well.

Let me end with the conclusion of our report:

> The local government sector has a large effect on the welfare of the community. It is important that it fulfils its proper role in the economy, that it uses resources wisely and that its regulatory activities are soundly based. The quality of the services provided by local government and their costs have an important effect on the international competitiveness of the economy. Local government performance is now a priority issue for many business organisations. There is some evidence of a slackening in performance, such as the tendency for rates to move up again, following the gains that occurred in the late 1980s and early 1990s. This must not be allowed to happen; productivity improvements in the local government sector must be part of overall efforts to maintain the present momentum of economic growth. The main conclusion of this study is that, while commendable progress has been made, there is still substantial scope to improve the contribution of local government to community welfare.

I hope your association will play its part in promoting that goal.

REGULATION AND COMMERCIAL LAW

ENTERPRISE NEW ZEALAND TRUST CONGRESS '95

THE ECONOMY AND THE ENVIRONMENT

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

WELLINGTON
21 AUGUST 1995

THE ECONOMY AND THE ENVIRONMENT

Some years ago, Guy Salmon, then director of the Joint Campaign on Native Forests, made a very interesting statement about some of the environmental consequences of the economic reforms which had been introduced in New Zealand. He said:

> ... Roger Douglas is the unsung hero of New Zealand's natural environment. Let me briefly list his achievements. He has cut off funding for the uneconomic clearing of native forests by government departments. He has obtained a firm phase-out period for swamp drainage subsidies. He has finally abolished the Land Development Encouragement Loan Scheme, which has funded the clearance of over 30,000ha of native forests since 1978. He has stopped concessional finance for building local authority hydroelectric dams. He has abolished the tax concessions used for land clearance by forestry companies. He is phasing out special tax deals for mining companies. His support for splitting up the Forest Service and Lands and Survey has been crucial to the creation of the Department of Conservation. By corporatising the State-owned enterprises he is setting up a framework which will curb the building of state-protected Think Big projects. Soon he will have State Coal Mines on the same basis as private enterprise, so that it no longer has legal powers to make pre-dawn raids on the pastures of Waikato farmers. In short, thousands of hectares of native forests, swamps, rivers and wildlife habitats are being saved by the dismantling of the structure of state-sponsored carnage. It is Roger Douglas, more than anyone else, who has made this such an exciting time to be an environmentalist.

This was a very perceptive comment by one of New Zealand's most intelligent environmental leaders. It prompts a number of reflections.

When we look back on the policy debates of the pre-1984 period, an obvious question that arises is: Where were the environmentalists when we needed them? To be sure, there were one-off campaigns against some of the follies of the time, such as the construction of the Clyde Dam. But there was little systematic interest by many environmentalists in the underlying policies which were causing so much environmental damage, such as the under-pricing of electricity for political reasons which brought forward the construction of power stations (and then contributed to the glut in energy which motivated the Think Big programme). Where environmentalists were engaged in the policy debate, they were more often than not on the wrong side. Through the 1970s, for example, environmentalists pushed for gas to be used in uneconomic liquid fuels schemes rather than in electricity generation, and supported interventionist approaches to energy conservation such as petrol coupons and carless days. They were generally hostile to markets and prices. The reforms Guy Salmon spoke of owed little to people who styled themselves environmentalists, although many of those associated with the reforms were as conscious of their environmental benefits as they were of their economic merits.

These stances no doubt reflected the prevailing climate of environmentalist opinion at the time. This tended to be unsympathetic to economic progress, regarding it as synonymous with environmental degradation. To many people it seemed obvious that our environmental problems were a consequence of consumerism, economic growth and the profit motive. Organisations like Greenpeace disliked the market system, and in politics many greens associated themselves with parties favouring heavy state intervention. This green tradition, according to Chris Trotter, continues to argue that:

> ... industrial society, through its capitalist institutions, inevitably alienates human beings from the natural environment and each other. The consciousness

> of industrial Man ... is, therefore, fundamentally exploitive, a fact freighted with disastrous consequences for both the natural world and the human species.

Over the last 15-20 years, however, there has been a marked shift in the intellectual climate. Experience around the world and developments in economic understanding have established a number of important lessons.

- First, economic development and environmental progress are much more in harmony than they are in opposition. Richer is usually cleaner. As countries' incomes rise, they can afford to spend more looking after the environment. People are more willing and able to trade off material progress for environmental benefits since both go to improving the quality of life. In poorer countries, relentless pressure on natural resources arises simply from the struggle to survive.

- Second, economic progress is associated with, and fueled by, improvements in technology. These give rise to products and processes that are usually cleaner, quieter, and less harmful to the environment. Advances in technology economise on the use of resources. Market competition spurs businesses to reduce waste and produce more with less. The contrast between fuel-efficient West German cars and the polluting and gas-guzzling Trabants just across the border in the former East Germany illustrated this point.

- Third, market systems are founded on the notion of property rights which are a powerful force for good stewardship and conservation. As St Thomas Aquinas put it:

  > ... private property is essential for human life. ... [E]ach person takes more trouble to care for something that is his sole responsibility than what is held in common or by many. ...[T]here would be chaos if everybody cared for everything.

  Collective ownership reduced incentives to care for property; as the Russian saying used to go, "Who will get up in the night to look after the sick cow?" Many of the worst environmental problems have been due to the so-called tragedy of the commons. Collective ownership means a conflict of interest for politicians - do they act to protect the government's interest as the owner of a polluting industry, or do they act to subsidise consumers of its products if prices have to rise, or do they act in the interests of those who are harmed by the pollution? To whom can the latter appeal if the government owns the industry, makes the laws, and appoints the judiciary?

- Fourth, market systems embody other valuable incentives as well, in particular prices. Prices signal the relative abundance or scarcity of resources, and guide them to their best use. As prices go up, demand is curbed, people switch to substitutes and new sources of supply become profitable. Economic systems based on prices rather than command and control mechanisms are forward-looking and reflect the interests of future generations: if resources are likely to be more valuable in the future, they won't be used today.

- Fifth, and by contrast, political decision making is much more biased towards the short term, typically the next election. Politicians face much stronger incentives to deliver benefits to present-day voters, often at the expense of the future. Consumption today is maximised at the expense of future consumption possibilities. Resource depletion and environmental clean-up are problems left to subsequent administrations to deal with.

All the problems associated with the suppression of market mechanisms, state ownership and reliance on political decision making processes were graphically illustrated by the environmental record of the former Soviet Union and Eastern Europe. A slogan of the Stalin era was: "We cannot expect charity from nature. We must tear it from her." In the name of material progress, Soviet governments tolerated and encouraged a 70-year assault on nature, poisoning rivers, fouling the air and ravaging once pristine and productive lands. The biggest rivers, including the Volga and the Don, became open sewers. In central Asia the desiccation of the Aral Sea was probably the greatest man-made catastrophe ever. Altogether three-quarters of the old Soviet Union's surface water is reckoned to be badly polluted. Massive soil erosion meant declining grain yields which changed Russia from being one of the world's largest grain exporters to a country requiring food aid. In some industrial towns, nine out of ten children suffered from pollution-related illnesses such as chronic bronchitis, asthma, allergies and cancer. Life expectancy has been falling, contrary to trends in almost every other part of the world. Chernobyl merely brought home the extent of what has been called ecocide in the USSR. As *The Economist* put it:

> Untrammelled power and conceit have produced an ecological and human disaster of biblical proportions. The consequences will have to be endured for generations to come.

We are talking here about a country that had no consumerism (there was nothing to buy), no profit motive (profits were illegal), and no genuine economic growth. Into the bargain, one giant common pool led to environmental ruin. Yet this was a country that was greatly admired by many New Zealand unionists and environmentalists who made common cause with them.

In the industrial countries which relied primarily on decentralised markets to determine the use of resources, the environmental consequences of economic progress have been far more benign. Of course this is not to deny that there are environmental problems in most Western countries, nor that there are often trade-offs between development and the environment. Difficulties still arise where resources are held in common and property rights are not easily specified - as in the case of sea and air pollution - although these are reducing with advances in technology. It should be the concern of all of us to take these problems seriously and find ways of mitigating them and making careful judgments about the trade-offs. On the other hand, it is also clear that many of the supposed environmental threats have been vastly exaggerated.

It is salutary to look back over the record of environmentalist doom-mongering. In Shakespeare's day, the prevailing fear was that London streets would be buried under mounting levels of horse manure. The Reverend Thomas Malthus predicted rising population in Britain would lead to mass famines. The 19th century economist Stanley Jevons wrote a book about the problems of the depletion of fossil fuels, particularly coal.

Nearer to our time, Rachel Carson predicted in 1962 that man-made chemicals might wipe us out within 20 years. In the opening lines of his book, *The Population Bomb,* Paul Erlich told us that:

> The battle to feed all of humanity is over. In the 1970s the world will undergo famines - hundreds of millions of people are going to starve to death ... .

The Club of Rome's *Limits to Growth*, published in 1972, predicted the exhaustion of gold by 1981, tin by 1987, petroleum by 1992, and copper, lead and natural gas by 1993.

In the 1970s Stephen Schneider, currently a leading proponent of action against global warming, predicted a new ice age. In the early 1980s, acid rain was supposed to be killing off the forests in North America and Europe; subsequent studies have refuted this theory. In 1984 the UN Environmental Programme claimed that 25 percent of the earth's surface was threatened by desertification; the latest data show no net increase in global desert area. In 1991 Carl Sagan predicted that smoke from torched Kuwaiti oil wells would lower global temperatures, causing droughts and famine in India and "massive agricultural failure" in the United States. And so on.

It is extraordinary how some of the leading doomsayers cling to their beliefs in the face of evidence and scientific reasoning. The story of the famous 1980 bet between Ehrlich and economist Julian Simon has become legendary in this regard. Simon offered to let anyone pick any natural resource and any future date, and he bet that the price would decline by that date. If the resource really became scarcer as the world's population grew, he reasoned, then its price should rise over time.

Ehrlich and two associates picked a basket of five metals - chrome, copper, nickel, tin and tungsten - then worth a total of $1,000, and chose a ten-year period. If the combined prices of the metals were higher in 1990 than in 1980, Simon agreed to pay the Ehrlich group the difference in cash; if the combined prices were lower, they would pay him the difference.

In 1990 Ehrlich sent Simon a sheet of calculations and a cheque for $576.07. Over the ten-year period, each of the five metals had declined in price when adjusted for inflation. The drop was so sharp that Simon would have come out slightly ahead even without the adjustment for inflation.

Prices of food and most natural resources have been falling for decades because of entrepreneurship and continuing technological improvements. Despite that fact, Ehrlich, who had predicted that "before 1985 mankind will enter a genuine age of scarcity" including food shortages, now says it will happen sometime in the next century.

The good news is that much of the bad news about environmental trends is wrong. Thus the London pea-soup fog of Dickens' day has virtually been eliminated, and the Thames is cleaner than it was in the time of Shakespeare. Lake Erie is no longer dead. Today 70 percent of the rivers in the United States are considered safe for fishing or swimming compared with 36 percent in 1972. Particulates and carbon monoxide emissions have been declining in the United States for more than 50 years. Ocean dumping of industrial wastes has been reduced by 94 percent. The total forested area of the world's temperate regions actually increased between 1980 and 1990. Overall death rates from cancer are declining, apart from smoking-related lung cancer. Although the world's population has tripled during the 20th century, food is more abundant and cheaper today than at any other time in human history. And as Alan Reynolds, director of economic research at the Hudson Institute, has written:

> The world is not running out of energy and never will. The problem is cost. Much of the potential energy remains unfound or unused because it is too costly to develop at current prices. We have recovered only one-third of the oil from existing wells. Heavy oil, shale and tar sands contain something like eight times the 'proven' reserves of conventional oil, and many areas of the globe have barely been explored for conventional oil and gas. If cheaper energy sources start to run dry, prices will rise and alternative sources will be developed.

Julian Simon argues that there is no convincing reason why these trends towards a better life should not continue indefinitely. The key requirements for progress are free economies, respect for property, and fair and sensible rules of the market. Basically what the prophets of doom overlook is the ingenuity of human beings to adapt, economise, conserve, find substitutes, and discover new knowledge to solve emerging problems.

There has been a spate of recent books that have put environmental issues into a better perspective. They include Ronald Bailey's *Eco-Scam : The False Prophets of Ecological Apocalypse;* Richard North's *Life on a Modern Planet;* Wilfred Beckerman's *Small is Stupid; Environmental Gore* edited by John Baden, a response to Al Gore's *Earth in the Balance; Apocalypse Not : Science, Economics and Environmentalism* by Ben Bolch and Harold Lyons; *Eco-Sanity : A Common-Sense Guide to Environmentalism* by Joseph Bast, Peter Hill and Richard Rue; *No Turning Back : Dismantling the Fantasies of Environmental Thinking* by Wallace Kaufman; *The True State of the Planet* edited by Ronald Bailey; and Matt Ridley's *Down to Earth.* These writings are not anti-green. As Ridley says:

> I am an environmentalist. There are issues I wish we would take more seriously, such as asthma, plastic litter, the decline of frogs and the loss of untouched forest to government-encouraged development. But I wish greens and lawmakers would try to devise real solutions that work with the grain of human nature, rather than whizzing round the world to glamorous conferences crying wolf about impending apocalypse.

Arguably, we in New Zealand have also got some of the environmental issues seriously out of balance. Like *The Dominion,* I would not greatly regret the loss of the kiore or native rat. I regard the opossum menace and the threat to some native birds as clear and present dangers that should preoccupy us more than some of the global environmental problems. No one should have a cavalier attitude to an issue like global warming. But while the greenhouse hypothesis may well be sound in broad outline, the likely extent of warming is still highly controversial, the detrimental or beneficial effects of warming are not well established, and the feasibility and cost of measures to mitigate the problem relative to any benefits are quite indeterminate at this stage. We do not even know if New Zealand would be a net beneficiary from any global warming (in which case countries which are not should pay us to adjust) or a net loser (in which case we should be prepared to incur real costs). All the logic points to a very cautious approach, particularly for a small country which is a negligible factor in the global context and not currently a net contributor to the problem - if indeed there is one.

Regrettably it is also the case that many approaches to policy originating from environmental sources are still misdirected. The interventionist Alliance programme would certainly be highly damaging to the economy, and, for that reason and others I gave earlier, I suspect it would be damaging to the environment as well. Specific policies such as progressive pricing for water and electricity are not only bad economics. Because many consumers would not face the true marginal costs of supply, progressive pricing would encourage excessive consumption and resource depletion and hence be bad environmental policy as well. It would also be an unfair policy, because those with a low personal demand would not necessarily be on low incomes, and because some of them would also be able to enjoy windfall gains by on-selling to others who would otherwise have to pay higher prices.

Similarly, the so-called 'precautionary principle' which some claim is relevant to an issue like global warming is bogus economics. Most economic decisions involve risk. There is no general rule which says you should err on the side of caution : not to take risks may be the biggest risk of all. Risks must be assessed and managed on a case by case basis.

With some notable exceptions, environmentalists are often still not there when we need them on a range of issues where good economics coincides with good environmental policy. Economists, not environmentalists, were the driving force behind the highly successful ITQ regime for fishing - a textbook example of the environmental benefits of secure property rights. In the coastal shipping debate, only the Maruia Society to my knowledge, and then only late in the day, recognised the environmental benefits of deregulation and weighed in in favour of it. As far as I know, no environmental organisation has taken up the issue of over-production and inappropriate decisions about land use resulting from the distorted pricing structures in the dairy industry, which is not only an economic cost to the country but is also creating discharge problems in areas like Southland. With the exception of the Maruia Society, environmental support for better pricing policies and more commercial approaches to infrastructural industries such as electricity, water and roading, which would have large environmental as well as economic benefits, is, at best, muted.

On the other hand, we need to worry about the costs that excessive environmental regulation may be imposing on the economy. The total public and private costs of meeting environmental regulations can be very high - in the United States in 1990 they were estimated at more than US$90 billion per year, well over New Zealand's national income. There is no doubt that the Resource Management Act has increased the costs of doing business for many industries in New Zealand. A commentator in the *Australian Financial Review* recently made a sobering point. He said:

> Even by introducing the most modern and best practices, it would be out of the question to obtain approval for many of our existing roads, dams, railways or mines. Irrigation schemes ... would generally face impossible barriers and the commercially viable building of new pulp and paper mills, chemical plants, abattoirs and many other factories would, frequently, be ruled out.
>
> Without these assets built in the past ... our standard of living would be vastly lower. If we don't keep building sensibly, future generations will suffer.

No one argues against sound environmental regulations. The debate needs to focus on the form such regulations should take. Insights from recent economic inquiry, particularly the so-called free market environmentalism literature, have provided a foundation for major improvements in policies affecting the use of environmentally sensitive resources. Recognising that the vast majority of resource use decisions are made privately in a decentralised market economy, these insights point in particular to a set of policies which harness the power of appropriate prices, private ownership (and the incentives for care that accompany it), and tradable ownership rights to influence environmental outcomes. Taxes and subsidies are seen as often superior to regulations in correcting for external effects. In this way, people are encouraged to think carefully about the value they put on resources and make careful trade-offs.

By contrast, preferences expressed through the political system are frequently much less reliable. An anecdote illustrates the problem clearly. A Russian being tested for his suitability for membership of the Communist Party was asked what, if he had two ploughs, he would do with them. One, he said, he would keep, and strive earnestly to raise the levels of ploughing productivity; the other he would give to the party.

After a similar answer when asked what he would do if he had two cows, he was then asked what he would do if he had two shirts. He became embarrassed and tongue-tied. "Why can't you answer this question?" his examiners said. "It's exactly the same as the earlier ones."

"But comrades," he said, "I do have two shirts."

The politicised approach to public participation, tribunal hearings, contingency valuations and all the other apparatus of political and regulatory decision making tends to reflect individual preferences in inaccurate ways, closes off options, imposes blanket solutions and often has unintended consequences. In the environmental area, as in many others, it should be a mechanism of last resort, not first resort. Stronger forms of environmental regulation should be reserved for areas where they are strictly necessary, such as those characterised by serious information problems and third party effects which cannot be dealt with in other ways.

Against the background of the failure of command and control approaches to economic and environmental management and a better understanding of the strengths of market processes, it is not surprising that a party like the Progressive Greens has appeared on the political scene. Both rising income levels and environmental enhancement contribute to the goal of improving the overall quality of life. Market-driven economic progress is essential to environmental progress. If these insights from worldwide experience are being absorbed in New Zealand, that represents very considerable progress in the political debate.

NEW ZEALAND BAR ASSOCIATION CONFERENCE

APPEALS TO THE PRIVY COUNCIL

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QUEENSTOWN
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APPEALS TO THE PRIVY COUNCIL

Earlier this month *The Economist* reported that one of the most popular acronyms on the Internet is IANAL, "I am not a lawyer". As the only IANAL among your speakers, I am something of a stranger and, doubtless, expected to deliver a dissenting judgment. I hope not to disappoint you. My position is that appeals to the Privy Council should not be abolished - at least not for the foreseeable future, and not until we have done a good deal to improve judicial decision making and the structure of our courts.

My background is in economics, but I expect this audience is well aware of the increasing interplay between the disciplines of law and economics. That interplay is personified by Richard Posner - Judge Posner, as he now is - who has long provided a useful bridge between the two disciplines in his writings.

In his 1987 Harvard Law Review centennial article, Posner cast doubt on the survival of law as "an autonomous discipline". On this platform, I very much bear in mind his opening remark:

> The idea that law is an autonomous discipline, by which I mean a subject properly entrusted to persons trained in law and in nothing else, was originally a political idea. The Judges of England used it to fend off royal interference with their decisions, and lawyers from time immemorial have used it to protect their monopoly of representing people in legal matters.

Posner's article goes on to point out the changes during his adulthood, from the early 1960s. At the beginning, he says, "just as society had left the design of bridges to civil engineers, so it could leave the design of its legal institutions to lawyers". But from there things have become much less clear. He points out that:

- political consensus disappeared;
- many fields of law became deeply entangled with political questions (in part reflecting the expansion of government);
- the US Supreme Court "pioneered an aggressive style of judicial activism";
- there was a boom in complementary disciplines, particularly economics and philosophy, leading to the development of the theory of public choice; and
- confidence in the ability of lawyers to put right the major problems of the legal system collapsed.

I would be astonished if any of you felt that none of those points were relevant to you, and to this debate. Clearly the subject of jurisprudence should be of interest to all users of the legal system and all who are interested in law and justice.

Staying with Posner, but moving to a more specific area, consider the topic of employment contracts. The result of judicial 'development' of the personal grievance provisions in the Employment Contracts Act and its predecessor legislation means that in this country employment contracts can only be terminated for cause (i.e. terminations must be justified). Not only that, but terminations must also be procedurally as well as substantively justified. My interest in the operation of the labour market in New Zealand leaves me in no doubt that all of this has produced a fine mess, primarily because we have lost sight of the 'contract' part of the employment relationship.

The alternative to a 'dismissal with cause' system is, of course, the 'employment at will' system under the common law. In a 1989 Cardozo Law Review article, Posner explained that:

> Employment at will is a corollary of freedom of contract, and freedom of contract is a social policy with a host of economic and social justifications ... . Employment at will happens to be the logical terminus on the road that begins with slavery and makes intermediate stops at serfdom, indentured servitude, forced servitude and guild restrictions. That should be a point in its favour.

He goes on:

> ... a free market institution as persistent and widespread as employment at will is presumptively more efficient than an alternative imposed by government. The reason it might be more efficient is not hard to find. Litigation ... is costly. Apart from these direct costs of legally enforceable universal tenure rights there are the indirect costs, potentially enormous, from the weakening of discipline in the workplace when workers can be fired only after a costly and uncertain proceeding. ... Consumers would be hurt, because these costs would be passed on (in part) in the form of higher product prices. Less obviously, workers would be hurt too. In figuring what he can afford to pay, an employer considers not only the direct costs of labor but indirect costs as well. ... Now in a sense just-cause protection is a fringe benefit, so the worker does not lose out completely, but it is by definition a benefit he did not want as much as he wanted a higher wage, or else the employer would have offered it to him... .

In a 1984 University of Chicago Law Review article, Richard Epstein has also dealt with this point in the context of emphasising the impact of rules designed for minority cases on the arrangements which apply to the majority:

> No system of regulation can hope to match the benefits that the contract at will affords in employment relations. The flexibility afforded by the contract at will permits the ceaseless marginal adjustments that are necessary in any ongoing productive activity conducted, as all activities are, in conditions of technological and business change. The strength of the contract at will should not be judged by the occasional cases in which it is said to produce unfortunate results, but rather by the vast run of cases where it provides a sensible private response to the many and varied problems in labor contracting. All too often the case for a wrongful discharge doctrine rests upon the identification of possible employer abuses, as if they were all that mattered. But the proper goal is to find the set of comprehensive arrangements that will minimise the frequency and severity of abuses by employers and employees alike.

Against that background, consider the Court of Appeal's decision last year in the *Brighouse* case. That decision illustrates defects not only in our employment law, but also in the approach taken by our Court of Appeal in a more general sense.

The *Brighouse* case related to managers in a business which was losing money under its existing ownership. The business was sold and the managers were given one month's notice of termination of their employment contract, as provided for in their written contract. That contract did *not* provide for redundancy compensation but the managers asked for redundancy. The previous employer offered one week's wages for each year of service but that was not acceptable to the managers. The matter then proceeded over a period of some three years through the Employment Tribunal, the Employment Court, and the Court of Appeal.

As you may know, prior to this case it was well understood, as Chief Judge Goddard had put it in a 1992 case, that "in New Zealand redundancy compensation is payable only pursuant to an individual or collective contract or redundancy agreement to that effect". But two years is a long time in our modern employment jurisprudence.

The Employment Tribunal concluded that the employer had dealt unfairly with the managers by both:

- failing to offer adequate compensation; and
- failing to communicate or negotiate about alternatives to redundancy, or about the quantum of compensation.

This view was essentially upheld by Chief Judge Goddard in the Employment Court, and by the 3:2 majority of the Court of Appeal.

The problem with the decision cannot be put any better than it was by Justice Gault, dissenting in the Court of Appeal:

> ... the Tribunal's approach would put employers in an impossible position. It seems to require employers, although under no legal obligation to do so, to pay by way of compensation upon dismissal for genuine redundancy such amount as the Tribunal subsequently determines is fair. If this is not done, the substantially justified dismissal is held to be unjustified as involving 'unfair' treatment ... .

Of the majority judges, only Justice Casey was prepared to acknowledge that the decision could be seen as "a radical departure from the earlier decisions of the specialist courts in this area". He acknowledged also that this was the result of conscious judicial activism in those specialist courts. He said:

> I can understand the manifest desire of the Tribunal and the Employment Court to secure fair treatment of such employees, particularly in the present climate engendered by restructuring and extensive dismissals, where redundancy payments have become commonplace in the major undertakings affected.
>
> ... in the absence of any legislative provision it is not surprising to see the Tribunal and the Employment Court reassessing the [earlier] approach to redundancy compensation, by seizing on the ability to take it into account as a factor in determining whether there has been an unjustifiable dismissal.

Is this any way to run our employment law? Is it not a totally unsatisfactory example of judicial decision making? It raises several serious questions:

- Has it any basis in the reality of the bargain between employers and employees?
- Why should the Court of Appeal condone the 'manifest' judicial activism of the Employment Tribunal and the Employment Court?
- Why on earth should we create an "impossible" situation for employers?
- Given that it was a decision by the slenderest of majorities, where was Justice McKay? And why was Justice Bisson roped in from retirement?

Now one of the features of the employment jurisdiction is that the Court of Appeal has the final say. It is *not* possible to have the matter reconsidered by the Law Lords in the Privy Council. Nevertheless, would anyone here bet against the proposition that, had the matter gone before the Privy Council, the majority Brighouse decision would have been reversed (and by 5:0)?

The *Brighouse* decision brings out two other points that are deeply disturbing in the current context.

First, the decision was a direct and conscious snub to parliament's intentions in passing the Employment Contracts Act. The government was quite clear that it did not want courts interfering in the area of redundancy compensation when no provision was made in contracts. The fact that the government now feels powerless to do anything about the problem merely reinforces the objectionable nature of the Court's action in usurping a policy making role which should be the preserve of democratically elected and accountable institutions.

Second, the *Brighouse* case brings out the tenuous grasp our courts, including the Court of Appeal, appear to have of even quite elementary economic concepts. There is no parallel in New Zealand to the sophistication in law and economics which is now commonplace in the US court system. The majority of the Court in *Brighouse* considered that the personal grievance procedure afforded a way of redressing the balance of bargaining power of the parties to an employment contract. However, the idea that there is any systematic inequality in bargaining power between employers and employees is a basic fallacy in labour law which was rightly set aside in the Employment Contracts Act. To quote Professor Epstein again:

> If such inequality did govern the employment relationship, we should expect to see conditions that exist in no labour market. Wages should be driven to zero, for no matter what their previous level, the employer could use his (inexhaustible) bargaining power to reduce them further, until the zero level was reached. Similarly, inequality of bargaining power implies that the employee will be bound for a term while the employer ... retains the power to terminate at will. Yet in practice we observe both positive wages and employees with the right to quit at will.

As another example of economic illiteracy, consider the following statement by Cooke P in *Telecom v Commerce Commission* (this is the judgment in which the court concluded you look to the dictionary to work out what the concept 'dominant influence' is all about):

> It may be theoretically conceivable, for instance, that one person could be in a position to exercise a dominant influence over supply, while another was in a position to exercise a dominant influence over price.

A legal academic asked me to critique this statement, preferably with the aid of a standard economic text. Being completely unable to make any sense of it, I referred him as a precaution to a leading Australian academic in the field. His reply was:

> I am afraid I cannot find a textbook statement to counter Justice Cooke: the proposition is so silly it does not arise once we understand what a demand curve is.

In the Business Roundtable submission on the Privy Council issue, we make reference to the equally disturbing decisions by the Court of Appeal on the *Goldcorp* and *Mouat* cases, and on a number of public law cases. All of this leaves me asking the umbrella question: What *is* going on here?

As a spectator, I see our senior resident judges giving strange decisions like *Brighouse*. In their only other visible role, we have seen some of them operating as amateur social architects producing or reinforcing some of the more disastrous pillars of public policy, such as the accident compensation report of Sir Owen Woodhouse, the social security report of Sir Thaddeus McCarthy and the social policy report of Sir Ivor Richardson. Although the last was properly dead on arrival, it perhaps served to underline how far some in the New Zealand judiciary have fallen behind contemporary standards of economic and social policy analysis.

The Solicitor-General correctly noted in his report that the Privy Council had reversed decisions of the Court of Appeal in half of the decided cases, an extraordinarily high figure. But in my view he brushed this finding aside much too lightly by dismissing it

as "differences in judicial philosophy". At the heart of the issue are surely the standard of judicial performance and judicial accountability.
The Independent broached this issue in a controversial article last year. I suspect we are going to see more such challenges. My enquiries of constitutional lawyers overseas suggested there was nothing untoward about that step in today's environment of greater judicial accountability. By comparison with some overseas jurisdictions, judicial accountability in New Zealand is weak. For example, judges rarely participate in professional settings such as law and economics conferences; we do not have world class law schools where cases are subject to rigorous academic scrutiny; and there is no provision for citizens-initiated recall of incompetent judges. The Privy Council is the only effective accountability mechanism for our senior judges.

Obviously enough, the Business Roundtable is particularly interested in the fate of commercial law in what is undoubtedly not an era of judicial restraint. The commercial community is one of the major users of the system. Most of the cases which now go to the Privy Council are commercial cases. Restraint and predictability are cardinal virtues for the business community. The inconsistency of the Court of Appeal has a real economic cost. It makes enterprises risk averse, and it raises the prospect that every transaction and every decision is in a sense conditional upon judicial approval. In other words there seem to be no claims which are being properly laughed out of Court - an advocate can dress up a duty of care, or a fiduciary duty, out of any circumstances if the law is declared by appellate judges in sufficiently sloppy terms.

The business community is well aware that, on numerous occasions over the past decade or so, the Privy Council has had to provide reminders of the importance of adhering to the primary rules in commercial cases - not least rules of contract and the upholding of what the parties to a particular arrangement have agreed before any dispute arose. It seems to us that the Privy Council has properly reversed Court of Appeal decisions which have failed to send optimistic plaintiffs away empty-handed, and have made up or remade equitable or tortious duties to provide a remedy.

Given these trends, it is critical that we review carefully the Privy Council issue. Increasingly our judiciary appears to be becoming politicised and to some extent parochial. It is also reacting to 'victimhood', perceived 'fairness' issues, media hype and pressure groups. At its most fundamental, these difficulties appear to reflect the dominance of an 'activist' judicial philosophy within the Court of Appeal. Developing in New Zealand only in the last decade or so, this is a judicial perception of the Court of Appeal's role as consciously shaping the law. The purpose of this shaping is not well articulated, although it appears to involve a touchstone of 'fairness', some assumptions about the legal and social culture of New Zealand, and the conscience of individual judges. In general, this approach is problematic. In the commercial law field, it is simply not acceptable. A commercial lawyer today is almost reduced to advising that, if a matter goes to court, the outcome will depend on who the judge is and on what he or she perceives to be fair on the day. In my view, law making should be the preserve of parliament and the courts should apply the law from a non-political perspective.

As well as this change in environment, we are beginning to be regulated by an increasing number of commissions, tribunals, specialist courts and other bodies (e.g. the Privacy Commissioner, Human Rights Commission, Employment Court, various Ombudsmen, Securities Commission, Commerce Commission, Race Relations Commissioner etc.) To provide the appropriate checks and balances there is a real need for a well-structured court and appellate system, developing legal policy and applying legal principles rather than dispensing social justice.

All this suggests it may be dangerous to deny citizens access to a non-politicised and impartial expert appellate system. The debate should focus on the real issue, which is the quality of judicial services. The issue is not one of sovereignty. If New Zealand chooses to have the Privy Council as its ultimate Court of Appeal, then that is a decision it is making as an independent sovereign state. Arguably it is an act of robust independence to resist superficial appeals to nationalism and retain an institution which may appear constitutionally anachronistic but which is providing an excellent service.

Currently we are in volatile times. We have an activist Court of Appeal which has attracted a lot of criticism, much of which is discreet because of ethical considersations or because of fear of retribution. We have difficult Treaty and sovereignty issues to resolve and we are moving into an MMP environment. These and other factors should lead us to tread cautiously. We should not change the present system on some political whim without proper consideration. There is no strong public or political constituency for abolition. We should learn from the MMP debacle where a major constitutional change was decided by a minority of registered voters, and it is now apparent that most of the minority that supported it did not understand what they voted for. Surely this experience demonstrates the need to think carefully and move slowly.

The weakest link in the present judicial chain is clearly not the Privy Council. Logic suggests that we should apply our minds first to remedying the most obvious weaknesses. In the last ten years the judiciary has remained one of the few unexamined New Zealand institutions. It is not a matter of calling into question its independence but, like the Reserve Bank, matching its independence with transparent standards of accountability and performance. This is a complex agenda which will take time to work through. We have made some suggestions in our submission on possible ways of improving the structure and performance of the courts. No doubt there are others worthy of consideration. The priority task should be to decide and implement the desirable reforms, and then allow time for the community to be satisfied that our judicial services are of the highest possible standard. Only at that point should we look at cutting the link with London.

NEW ZEALAND ASSOCIATION FOR MIGRATION AND INVESTMENT
ANNUAL CONFERENCE

BUYING BACK THE FARM

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AUCKLAND
21 JULY 1995

BUYING BACK THE FARM

In recent years representatives of the Business Roundtable have spoken to your conference about immigration. We see the present immigration situation, particularly the reversal of the net population outflow of the 1980s and the attractiveness of the country to enterprising immigrants today, as part of New Zealand's remarkable turnaround as a country. Immigrants are bringing us additional capital, skills and ideas, and are providing new market linkages which are vital to international competitiveness. Immigration policy and administration can still be improved, but generally we see them as headed in the right direction.

Today I propose to speak about the other side of your Association's interests, namely the promotion of overseas investment. Over the years there have been periods of debate about foreign investment, and there has been another in recent months. Concerns have been expressed about the extent of foreign investment in New Zealand companies, overseas control over the economy and a loss of sovereignty.

It is not good enough in my opinion simply to dismiss these concerns as xenophobia. Rightly or wrongly, people hold them. If we think their concerns are misplaced, it is incumbent on us to point out why. Most reasonable people will respond to facts and sound arguments. If, at the end of the day, some wish to maintain their views on emotional grounds, we can at least hope to bring out the costs to the community - in terms of jobs and living standards - of their position.

There is a tendency to regard large international flows of capital as a very modern phenomenon, associated with today's so-called global economy and with trends such as privatisation and deregulation of financial markets. This is a quite incorrect perspective. As Paul Samuelson writes in his standard economics textbook:

> The nineteenth century was worlds apart from today. You could travel freely with no passport or even migrate freely from country to country. You could expect low tariffs and no trade quotas. You knew the international gold standard would let you transfer capital from place to place at your slightest whim.

New Zealand's early European settlement took place, of course, in precisely that environment. In its nineteenth century heyday, Britain invested around half its savings abroad, in developing countries such as New Zealand. If there had been balance of payments statistics in those days, New Zealand settlers might have wondered how they would ever repay all that capital. Practically the whole of the meat industry, for example, was British-owned for many decades. But the point about foreign investment is that it adds more to national wealth than to the income of foreigners. Over time, New Zealand was able to "buy back the farm".

At times this century, attitudes towards free capital movements have been less favourable. More nationalistic views favouring government intervention gained currency. As usual, this was one of the economic consequences of Mr Keynes. "The decadent international but individualistic capitalism ... is not a success ... we dislike it, and we are beginning to despise it ...", he wrote in 1933. In the 1960s, the United Nations body UNCTAD campaigned against investment by multinational companies. Today it has joined other international organisations in urging developing countries to pursue liberal trade and investment policies and to welcome multinationals. Increasingly, emerging countries are following this advice. Last year, China took in around US$35 billion of foreign direct investment.

Why this turnaround in attitudes again after the experience of the last 50 years? I don't believe it is because people have any less interest in goals such as economic security and control over their own destiny. What has changed is our understanding of the means of achieving those goals. When we attempted to close ourselves off from external influences, as we did in our quest for security in the 1950s and 1960s, we became less competitive and less flexible as an economy, and hence less secure and more vulnerable to outside events. That lesson has still not been absorbed by some. A regular contributor to newspaper letters columns, John O'Neill, wrote recently:

> "Fortress New Zealand" is not, of necessity, a bolt-hole from which we would look out in fear, but a sanctuary that others might regard with admiration.

That idea of a strategy for economic security was mugged by the reality of New Zealand's economic crisis of 1984 and the collapse of the Berlin Wall five years later.

I want to concentrate on the concerns about foreign investment that are being expressed today, but first it is useful to remind ourselves of some of the benefits. In general, these are not denied by most participants in the debate. Despite bouts of controversy, New Zealand in fact maintained a quite liberal policy on foreign investment well before 1984. What basically changed in 1984 was the stance on outward investment; with the removal of exchange controls, New Zealanders' savings were no longer trapped in their own country. They were able to diversify their portfolios and reduce investment risks.

Foreign investment is an addition to the investment that can be financed out of New Zealanders' own savings. Throughout our modern history, New Zealanders have not had much difficulty accepting the case for this additional investment. It provides the opportunity for a higher rate of economic growth. If we restricted capital flows, domestic interest rates and the cost of equity capital would be higher. Statistics New Zealand has estimated that in 1993 foreign-owned firms accounted for 17 percent of all employment - 204,000 full time equivalent jobs - and 33 percent of manufacturing employment in New Zealand.

Foreign investment not only augments New Zealand's supply of capital. As is frequently remarked, it often brings with it new management methods, new technology and access to new markets.

It's not difficult to see the difference international management expertise has made to companies like Carter Holt Harvey, New Zealand Post and the Bank of New Zealand. Telecom has benefited enormously from the access to technology which its shareholders Bell Atlantic and Ameritech have provided; it is now an international-class company delivering vastly improved services to New Zealand consumers. Heinz-Wattie is reaping the benefits of access to the Heinz brand name and its worldwide distribution network. Its exports are now running at over $200 million annually, up from below $100 million prior to 1992.

The same story can be told in virtually every part of the country. Discussing the foreign investment issue in a recent editorial, the Christchurch *Press* pointed out that Trimble Navigation, a Californian satellite-navigation company, employs 120 people in Christchurch where it develops specialist software and systems. Dynamic Controls, a subsidiary of Invacare Corporation, also of the United States, employs people making computer controls for power wheelchairs in Christchurch. Aoraki Corporation, which has grown to employ more than 500 people, was made possible by American investment in the Christchurch-developed Linc software. A British-owned company manufactures commercial kitchen equipment in Christchurch for world markets. An Australian-owned company makes electric ranges. Toyota has been a leader in passing on Japanese management and quality techniques to South Island manufacturers. As *The Press* noted, these are all foreign commitments to New Zealand that help Christchurch to survive and prosper.

always hardest hit by capital flight. The unemployed would lose out because investment and job creation would be lower than otherwise. Home owners would almost certainly face higher interest rates on mortgages.

However, the indirect effects of any significant action to limit foreign investment would go well beyond these direct effects. The general risk premium on New Zealand assets has declined significantly over the decade since New Zealand began its wide-ranging economic reforms and became more integrated into world capital markets. If we were to backtrack, there would be a loss of confidence in the country's direction, an increased country risk premium, and a fall in the value of the New Zealand sharemarket. Investors - foreign and domestic - would conclude that if New Zealand was foolish enough to take such a step, worse would inevitably follow. Ironically, given the political constituency for such a course of action, those who would be among the most affected by such developments would be people dependent on investment income, particularly those in retirement.

Of course, capital investment - whether of foreign or national origin - can be socially inefficient if governments grant investors tax breaks or subsidies, or confer quasi-monopoly positions on firms by protecting them in capital or product markets. The answer to this problem, however, is not to restrict foreign investment but to remove the subsidies and the barriers to competition, as New Zealand has largely done.

In general, therefore, I conclude that a liberal policy on foreign investment has much to commend it, both for traditional reasons and for the greater constraints it places on governments today to follow sound policies. As the World Bank has put it:

> ... the discipline imposed by the mobility of savings - on macroeconomic policy, governance and institutions - may even be more important than the direct gains involved.

One effect of globalisation is to expand the options open to private individuals and firms, while reducing those of policy-makers. That is why some resist the trends.

It's easy to gain influence and stir up popular sentiment against "gnomes of Zurich," and harder for politicians to explain that such fears, like gnomes, are indeed mythical. But the ultimate question New Zealanders must ask themselves is this: What economic and social costs as a nation are we prepared to bear for the benefit of nationalistic or anti-foreigner self-gratification? The real issue is whether we will use all available resources - including foreign capital, expertise and technology - to develop the growth potential of New Zealand and create productive jobs for our children. As an Association with a strong interest in sensible answers to those questions, I urge you to join in the debate.

PRIVACY ISSUES FORUM 1995

DISCLOSURE OF EMPLOYEE REMUNERATION

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29 JUNE 1995

DISCLOSURE OF EMPLOYEE REMUNERATION

Introduction

Among the many statutes enacted in 1993 were the Companies Act and the Privacy Act. The former was enacted to, amongst other things, "reaffirm the value of the company as a means of achieving economic and social benefits". The latter was enacted to "promote and protect individual privacy". This paper concerns a provision in the former which is in total conflict with both ideals.

The provision is section 211(1)(g) of the Companies Act 1993, which requires the disclosure of employee remuneration. Under this provision, a company's annual report must state, in bands of $10,000, the number of employees who received remuneration and other benefits in excess of $100,000 during the relevant financial year.

This provision was inserted into the Companies Bill at the eleventh hour with no opportunity for public submission and debate. The rationale for the provision was never set out by the minister and no sensible justification has been put forward to this day. No analysis appears to have been done as to whether the benefits (if any) of the provision would exceed the costs, nor was any attempt made to assess the costs of complying with it. The legislation clearly flies in the face of almost simultaneous legislation designed "to promote and protect individual privacy". The Privacy Commissioner failed to respond to requests to comment on the privacy aspects before the law took effect. Moreover, subsequent approaches for his views on the issue have drawn no clear response, although he indicated in a speech earlier this year that he would welcome views on its justification and hoped the matter could be revisited by Parliament. All in all, this is one of the most shabby episodes in a programme of corporate law reform which has had more than its share of failings.

The provision concerns employees, not directors

It is important to be clear what the provision we are discussing does, and what it does not, concern. In particular, it should be noted that the provision does not concern *directors*, but *employees*. There have long been provisions in companies legislation concerning disclosure of directors' remuneration. These requirements were extended by the 1993 company law reforms. However, there has never been a requirement for disclosure to shareholders (whether in the annual report or otherwise) of any aspect of *employee* remuneration.

Traditionally, company law distinguishes between the fundamentally different roles of directors and employees. Directors are agents for shareholders, making decisions on their behalf which they cannot efficiently make collectively. They have certain fiduciary duties and must be above any suspicion of self dealing. Employees, on the other hand, are not generally fiduciaries. Their relationship with the company is, rather, governed by their contract of employment. It is one thing to suggest that directors, as fiduciaries, should be required to disclose their remuneration to shareholders. It is quite another to suggest that employees, who simply contract with the company for the provision of their services, should also be subject to remuneration disclosure requirements.

Disclosure is mandatory for all companies

The requirement to disclose bands of employee remuneration is mandatory. Shareholders are not free to assess whether the costs of this disclosure outweigh the benefits and to decide accordingly by the usual majority vote. Rather, the Act requires every company to include this information in its annual report, unless all shareholders agree to its non-inclusion.

It should also be noted that the requirement applies to all companies, from the smallest family businesses to the largest publicly listed New Zealand companies. Obviously, it is more likely in smaller companies that unanimous shareholder agreement to non-disclosure will be obtained.

Companies that are required to prepare group financial statements must also disclose the information in relation to their subsidiaries. A New Zealand company with a Swiss subsidiary is therefore required to disclose the numbers of its Swiss employees in each $10,000 remuneration band above $100,000. It may come as news to the Swiss that $100,000 is a 'high' salary. Large numbers of employees worldwide are caught by this provision.

Are there reasons for mandatory disclosure of employee remuneration?

Employment contracts are contracts like any other - the Employment Contracts Act has reinforced that concept. There is no requirement that equivalent information concerning other contracts that a company has entered into be disclosed in the annual report. Companies need not disclose the level of payments made to their professional advisors, their cleaning contractors, or their suppliers of raw materials. Commercial confidentiality is preserved for good reason, and no more so than in the salaries area in the past. What, then, might justify a new requirement for disclosure of certain levels of employee remuneration? What makes this information so important that only unanimity amongst shareholders can dispense with the requirement? Let us consider the possible arguments.

- *Increasing available information* A simplistic justification may be that it will increase the supply of information available to persons dealing with companies. "Some information is good, so more information must be better." But this simply ignores the costs that may be associated with collating and disclosing such information, some of which are outlined below.

It also ignores the dangers of presenting an incomplete picture. Whether a given level of remuneration in a company is 'appropriate' will depend on many things other than what that level is. The degree of job security, the riskiness of the company's business, the company's performance, the nature of the job, and the needs and wishes of the company's shareholders will all be relevant. To require the same disclosure from all companies implies that meaningful comparisons can be made on the basis of levels of employee remuneration alone. This is incorrect, and invites erroneous comparison and misperception.

In general, the salaries of New Zealand executives are not high by international standards. However, it is inevitable that adverse comment will be made when companies disclose remuneration levels, particularly given the context-free nature of that disclosure. Dealing with enquiries about the information will be a time-consuming and thankless task for companies, and ultimately an unrewarding one given the complex incentives now built into many remuneration arrangements which make them difficult for outsiders to comprehend.

- *'Fairness'* Might it simply be that it is 'fair' to require this disclosure? Without any supporting analysis it is difficult to see to whom it is 'fair'. Is it 'fair' to the employees concerned? Is it 'fair' to the companies who must bear the costs of collating and disclosing the information? Is it 'fair' to the shareholders who do not wish such information to be disclosed? In the absence of rigorous analysis of all the likely costs and benefits, simple appeals to 'fairness' are deeply unpersuasive.

- *Improved efficiency* Alternatively, it may be alleged that such disclosure will somehow improve the efficiency of the labour market for management services. However, if this argument were to hold, it would also be valid for partnerships, trusts and other non-company forms of organisation, none of which are subject to disclosure requirements. Efficiency is normally enhanced by secure property rights, and abrogating the company's rights to its own information by mandatory disclosure is presumptively inefficient.

- *Shareholder protection* It might be argued that disclosure is necessary to protect shareholders. But why is it that directors can be relied upon to oversee and manage the company's entry into all manner of contracts without having to disclose any details of them, but that when it comes to employees paid over a certain arbitrary level, disclosure requirements apply? Company directors have been free to disclose such information in the past but few, if any, have done so, which suggests that they did not regard disclosure as being in the best interests of shareholders. For their part, there was no widespread clamour by shareholders for disclosure.

- *Public / government 'right to know'?* Various public sector salaries are required to be disclosed. Might it be that there is some sort of corresponding public and/or governmental benefit in mandatory disclosure of company employee remuneration levels?

There are obvious reasons for the disclosure of remuneration of parliamentarians, judges and senior public servants. Members of Parliament are the agents of their principals, the electorate, and, as with the shareholder/director relationship, the principals have a legitimate interest in knowing what their agents are paid. In the case of judges and senior public servants there are few market checks on excessive salaries and, in addition, there is a case for transparent arrangements to provide protection against political influence and patronage. Accordingly, an independent body sets salaries in all these cases and disclosure is appropriate. No such considerations apply to private sector company employees. Market competition is the key constraint on salaries being set at excessively high or excessively low levels. Capital market disciplines, including the threat of takeovers, penalise such behaviour. Hence the terms of employee contracts have not hitherto been regarded as the business of the wider public. In any event, the new provision does not require disclosure to the public but merely to shareholders, and only in the case of major listed companies will it effectively mean public disclosure. Moreover, if disclosure serves a public good, why can it be waived by shareholders, albeit only unanimously?

One is left with the lingering suspicion that the true motivation for the requirement is an unfortunate mixture of curiosity, unspoken envy of those whose annual incomes are perceived in some sense to be 'high', unthinking adoption of similar requirements in other jurisdictions (in ignorance of the fact that the United Kingdom has recently abolished similar requirements in its own companies law), and some sort of general 'gut feeling' that this disclosure is in some way 'good'. Many of the same motives have driven other ill-considered initiatives such as New Zealand's poorly-conceived insider trading law which fails to adequately acknowledge property rights in information, and the proposed equal price provisions in takeover regulation. There is negligible support for mandatory disclosure of employee salaries in the academic literature on the subject.

Problems with the provision

- *The private nature of remuneration* Income in free societies - whether from wages and salaries, entrepreneurship or investment - has generally been regarded as a private matter. Only in 'big brother' societies have private incomes been seen as the business of the state. In a paper delivered earlier this year to company secretaries and corporate managers, the Privacy Commissioner said: "I am continually finding that there is in the New Zealand community an expectation of privacy in relation to remuneration".

There are many factors which probably re-inforce such social attitudes in a New Zealand setting. One is the difference in attitudes to personal wealth in New Zealand compared to countries such as those in North America and Asia. Whereas wealth tends to be regarded favourably in such cultures - the multi-billionaire Li Ka-shing is easily Hong Kong's most admired citizen, for example - in New Zealand a misplaced notion of egalitarianism often leads to disparagement of those on high incomes. A right to privacy in the face of such attitudes ought to be a feature of any privacy law.

A related factor may be fear of the 'tall poppy' syndrome. This fear may not be misplaced if the provision considered in this paper is anything to go by. Disclosure is required for all employee packages which exceed a specific dollar figure irrespective of the role played by the relevant employees, their security of tenure, the contribution they have made to company wealth, or any other relevant factors. This fixation with absolute levels of remuneration, in isolation from other relevant information, leads to a strong suspicion that curiosity, envy or attitudes towards 'tall poppies' may be the true motivation for the requirement.

- *Disclosure will often not be anonymous* It is not open to the proponents of employee remuneration disclosure to argue that no individual's salary will be known because the disclosure need only specify how many employees fall within the $10,000 bands. In a very large company, it may be difficult to determine which particular band some managers fall within. In a smaller company, however, it will be much easier. And in the large companies, it will not be difficult to make an informed guess as to the identity of those employees in the upper bands. There will therefore be an appreciable number of employees whose level of remuneration will no longer remain a private matter.

If analysis were available showing good reason to believe that the benefits of such disclosure would outweigh the costs, such intrusions into personal privacy might be acceptable. In the absence of such analysis, however, they are simply unjustified violations.

- *Compliance costs* The costs which are likely to result from this new disclosure requirement are not insubstantial. At a technical level, the provision is not well drafted. Considerable expense has already been incurred by many companies, both in terms of executive time and by way of legal and accounting fees, simply in ascertaining what must be disclosed. Assessing what constitutes an employee benefit and how certain benefits should be valued is not always a simple matter. Further costs will be incurred in collecting and collating this information and including it in annual reports.

In this respect, the experience in the United States is instructive. Analogous US disclosure requirements are dense and detailed, with specified tables for the assessment of benefits such as share and option schemes. Few people really understand this information. But it has, apparently, been felt necessary to legislate to this level of detail to avoid incomplete or inconsistent disclosure. Significant expenditure is reported to be incurred in complying with these disclosure requirements.

- *Avoidance costs* A further cost which, ultimately, companies will bear is the cost associated with the inevitable attempts to avoid the relevant disclosure requirements. Not only have companies already spent considerable sums of money just in assessing what must be disclosed, they are also likely to meet with demands from employees for methods of compensation which do not fall within the requirements, or which minimise the disclosure required. The fringe benefits 'industry' which flourished under our former tax laws may get a new lease of life. Whether such initiatives prove 'successful' or not is, in a sense, beside the point. Of more importance is the fact that shareholders' money will be spent on a task which will not increase their wealth one iota. The main winners will be inventive lawyers.

At the margin, avoidance is also likely to take the form of adopting business structures which are not caught by the legislation. Trusts, partnerships and private companies whose shareholders will vote for non-disclosure are obvious possibilities. Some listed companies may find going private even more attractive, thereby reducing investment opportunities for the public. Whenever business decisions are biased in this way by inappropriate regulation, the economy is made less efficient and community income is sacrificed.

- *Reduction in willingness to link pay to performance* There is also reason to believe, on the basis of some tentative empirical work in the United States, that such disclosure requirements may act to diminish the enthusiasm of boards of directors for the introduction of performance-related remuneration packages. If this does turn out to be one effect of the requirement, shareholders will have been doubly ill-served. Not only will they be saddled with needless corporate expenditure but they will also be denied the benefits which would otherwise accrue to them from such packages.

There is increasing recognition worldwide that a useful way to align the interests of shareholders with the interests of managers is to provide management with financial incentives to increase shareholder wealth. Thus in recent years there has been increased interest in various performance-related remuneration packages, ranging from share and option schemes to, more recently, EVA-type schemes.

An employee who significantly adds to shareholder wealth and whose remuneration is closely linked to increases in shareholder wealth stands to benefit from his or her labours. Correspondingly, an employee who does not make such a contribution will not receive such a benefit. However, if there is a requirement to disclose employee benefits above a certain level, only the benefits paid to the successful employees may be disclosed. When employees have been particularly successful, their benefits may be particularly large. In a society still partly characterised by socialistic attitudes to equality, this may well lead to adverse comment. Such comment, of course, will be entirely unjustified if it focuses solely on the level of the benefits received and not on other circumstances, such as the contribution of the employees, their security of tenure and the extent to which their jobs were at risk if they did not perform. But the fact remains that such comment will be made.

Some reports from the United States suggest that the fear of this sort of adverse comment can inhibit boards of directors from approving remuneration packages which closely link pay to performance, and under which some employees stand to make a lot of money. As a result, employees will not have the same incentive to increase shareholder wealth. Moreover, as a natural economic reaction to this 'ceiling' on employee remuneration, one can expect to find a 'floor' underneath it, as employees with less opportunity for performance-based pay demand compensation for this in the form of higher minimum benefit levels.

- *Higher compensation demands from employees* Finally, one should not forget the effects on the employees concerned. Their privacy will be invaded. Particularly in a small community, this may increase their susceptibility and that of their partners and children to risks ranging from unwanted publicity and abuse to burglary, kidnapping and extortion. Concerns have been expressed both in Australia and the United States about the possible effects of compulsory remuneration disclosure. Employees can be expected to require compensation for this intrusion into their privacy, in the form of increased remuneration levels. There is, in fact, speculation in Canada and the United States that higher remuneration levels may be a direct result of remuneration disclosure requirements - a further cost to shareholders of a requirement which delivers them few, if any, benefits.

Conclusion

Legislation should only be enacted with a clear conception of its purpose and on the basis of careful analysis which demonstrates how it will achieve that purpose and generate benefits that will outweigh its costs. The requirement to disclose levels of employee remuneration meets none of these criteria. It was enacted for no sensible purpose, on the basis of grossly insufficient analysis, with scant regard for its likely costs and with little thought for the interests of those affected (principally employees and shareholders).

At a time when New Zealand is still plagued by the politics of envy and is struggling to develop an enterprise culture, we need this legislation like a hole in the head. It is tailor-made for populist politicians and tabloid journalism. As remuneration starts to be reported over the next year or so, we can expect sound, fury and moralising which will signify nothing but bad news from the point of view of genuine shareholder interests and New Zealand's business environment.

What ought to be done? I suggest three things:

- First, there is a major task of public education about the nature of the international market for managers, the pressures and responsibilities on top executives and the link between pay and performance. Efforts by managers or organisations representing managers to explain these factors will only appear self-serving. Directors set the highest levels of pay in a company and the Institute of Directors supported the legislation. It will be incumbent on company chairpersons and the Institute of Directors to take up the education role.

- Second, the privacy implications of the legislation must be clarified. It is incumbent on the Privacy Commissioner to make his views known without further prevarication.

- Third, the government should, at the earliest opportunity, follow the lead of the United Kingdom and scrap this unprincipled legislation.

NSW BRANCH OF THE AUSTRALIAN
AGRICULTURAL ECONOMICS SOCIETY

INTO THE MUSEUM - AGRICULTURAL MARKETING BOARDS I HAVE KNOWN

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ACIL ECONOMICS AND POLICY PTY LTD

SYDNEY
30 NOVEMBER 1994

INTO THE MUSEUM - AGRICULTURAL MARKETING BOARDS I HAVE KNOWN

In my twenty-five years or so professional involvement in the agricultural policy arena, a wide range of agricultural marketing boards have crossed my path. I have been a board member of one - the Australian Meat and Livestock Corporation. I have done work for several, including the Australian Wool Corporation in the dying days of the reserve price scheme. I helped bring about the demise of one - the NSW Egg Corporation - but my valiant efforts were not successful in terminating the operations of another - the then WA Lamb Marketing Board - although the days of its successor (the WA Meat Marketing Corporation) now appear to be numbered.

Tonight I want to share some experiences ACIL has had in recent years analysing agricultural marketing arrangements across the Tasman. My colleague, Denis Hussey, has led most of our research and would rate as the best informed analyst anywhere on the New Zealand debate. But I have been close enough to him for long enough to hope I can do justice to the subject.

There are some important lessons to emerge from the New Zealand experience which an Australian professional agricultural audience would do well to ponder.

In the first place, there is the matter of who is driving the debate. Unquestionably, the catalyst has been the New Zealand Business Roundtable (NZBR), the equivalent of the Business Council of Australia. Its interest is not - as has been asserted by those keener to play the man than the ball - that some of its avaricious members are trying to create and then pick over the carcase of time-tested structures. Rather, the explanation is that the Business Roundtable takes an utterly consistent approach to issues of competitiveness, government intervention and economic performance anywhere, and that its agenda is extensive. The quality of policy debate in Australia would be far greater were there more New Zealand Business Roundtables involved.

We were commissioned in mid-1990 to undertake a comprehensive analysis of agricultural marketing structures in New Zealand. The work proved somewhat bigger than anticipated and it was not until October 1992 that ACIL's report - *Agricultural Marketing Regulation: Reality Versus Doctrine* - hit the streets. As the NZBR chairman said in the preface:

> The primary purpose of the Business Roundtable is to contribute to the development of policies which reflect overall national interests... . [The study was commissioned] to ascertain whether there is anything special about agricultural products which continues to justify the present extent of intervention.

The report provided a thorough in-principle analysis of objectives, markets, prices and structures before applying these principles to the five industries in which statutory marketing authorities - or producer boards - are found: apples and pears, dairy, kiwifruit, meat and wool.

To ensure the report's conclusions quickly became known to farmers, a summary version was inserted into the main rural newspaper which is sent to every New Zealand farmer every week.

The main thrust of the report can be summarised as follows:

- there is essentially nothing special about agriculture which warrants the raft of regulation and intervention which has built up over the years;

- marketing objectives are wrong when they focus on maximising farm gate prices, rather than profitability;

- farm gate prices usually comprise a 'bundle' of items - different returns achieved in different markets, and off-farm investments in processing and marketing - which, when received by farmers, creates incentives which distort profit-maximising output on the farm;

- maximising farm gate prices also provides the wrong incentives to marketers;

- farmers have frequently advocated regulation to correct what they believed to be market failure, whereas it is usually the intervention which caused the market failure; and

- most important, most of these effects were not transparent and farmers, marketers, officials, politicians and academics had little idea of their effects or magnitude.

To give you an idea of the magnitude, New Zealand dairy farmers have off-farm investments of around $4 billion via dairy cooperatives or the Dairy Board. This is about $300,000 per farm on average. If those investments earned normal rates of return, say 12 percent, every New Zealand dairy farmer should receive an investment return of $36,000 before receiving any income from milking cows. This is between one quarter and one third of the farmers' total milk receipts - clearly not a trivial amount.

ACIL's report recommended that virtually all the regulations should be removed and the producer boards corporatised - with tradeable shares being issued to farmers.

By the time the report appeared, some key farmer leaders, while not understanding all the details, had an intuitive feeling that all was not well. Therefore the public statements from Federated Farmers (the NFF equivalent) urged that the results be studied. Privately, these leaders were quite sympathetic to the report.

The producer boards, most of which refused to cooperate with the study at all, certainly didn't see the recommendations as being in their interests. At first, they tried to ignore the report, hoping it would just go away and gather dust. Then they started attacking it, using all the familiar techniques:

- "it's far too theoretical";

- "competitive exporting would be hopeless in a distorted and subsidised world market";

- "weak selling would drive down prices and make all New Zealand farmers peasants";

- "the concept of bundled farm returns, while correct in principle, is trivial in practice";

- "most commercial firms bundle their returns in a similar fashion"; and

- "what would an Australian firm of consultants know about New Zealand agriculture" (even if the team leader grew up on a New Zealand farm and was educated there!).

Our client, the Business Roundtable, had no intention of letting the debate die. It arranged various speaking visits for Denis Hussey to keep the pressure up, and commissioned several pieces of follow-up research on more specific issues.

Within a few months we began to receive informal feedback from some of the boards that our analysis was being taken seriously, even if public commentary was still dismissive or critical. After about a year, the boards began to refer to 'bundling' as if they had known all along what it involved and implied. I am sure they were being encouraged behind the scenes by the more informed farm leaders, some officials and even a few politicians who could see that reform was inevitable, and would benefit farmers and New Zealand.

Against that background and brief chronology, I would now like to turn to consider the current state of play in the various industries, before suggesting how it might develop and drawing implications for Australia.

Wool

The wool story is a comparatively simple one. The New Zealand Wool Board previously operated an intervention scheme not dissimilar to our reserve price scheme and it came unstuck at about the same time and for the same reasons. The wool stockpile, which peaked at one quarter of a season's production in 1992, is now reducing rapidly and prices are recovering.

The Board has voluntarily decided to relinquish most of its statutory intervention instruments, except the power to collect a levy, fund generic promotion and research activities, and sponsor trials of a limited range of commercial initiatives. Thus, all powers to trade, set prices, develop QA schemes and control shipping arrangements are in the process of being withdrawn - at the Board's initiative and with the support of growers. Indeed, some grower leaders are questioning whether a Wool Board is needed at all.

Meat

The story with meat is similar to that of wool, although the New Zealand Meat Producers Board is resisting letting go of the apron strings. The meat situation is complicated by a long history of government involvement in meat processor regulation and farmer cooperative ownership, causing banks still to have a fair degree of exposure, and by the recent collapse of two major processors, Fortex and Weddel.

Nevertheless, the direction of reform is clear and it is highly significant that when Fortex and Weddel did fall over earlier this year in quick succession, both Agriculture Minister Falloon and the leaders of Federated Farmers immediately and solidly stamped on any suggestion that re-regulation or a bail-out was even an option. On the contrary, they said, some casualties were an inevitable, even desirable, consequence of the conversion to normal commercial structures with minimum intervention.

A recent review of the meat and wool boards commissioned by Federated Farmers has reinforced that view.[1] It presented four options ranging from the status quo through to generic legislation only - that is, no legislation specific to the wool or meat industry. While the report, which is now circulating among farmers for debate, did not recommend one single option, the tenor of its analysis clearly favours less regulation as the means to improving efficiency and competitiveness. The Boards are really not seen to be needed any more.

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1 Scobie Economic Research, Source Consulting, and A.S. Watson (1994), *Review of Institutional Arrangements for the Meat and Wool Sectors*, September 1994.

Meanwhile, a number of former NZMPB powers, such as its shipping powers, are no longer being used as more responsibilities are being taken up by meat processors where they belong. The main item of continuing regulatory debate is the appropriate mechanism for allocating entitlement to the North American beef market, where the logical approach of treating it as an asset in perpetuity (that is, as a tradeable item analogous to the abattoir plant itself) has not been accepted by the industry. This is because some fear that the value of entitlement would then be seen by North American interests as 'too visible', perhaps exposing it to the risk of retaliatory action, and because there is an (erroneous) feeling that meat companies shouldn't be given such gifts. As a result, the alternative of an earned entitlement scheme brings with it inadequate New Zealand capture of the full premiums available, and some associated distortions.

Apples and Pears

In many ways, apples and pears have been New Zealand's most rigidly controlled agricultural industry over the past 40 years. The New Zealand Apple and Pear Marketing Board has enjoyed not only single seller status on the export market, but has also controlled domestic sales. New Zealand's 1200 growers have received little information from the Board, apart from farm gate price data, so they have had no real way of judging the Board's performance.

Since the publication of the ACIL report, and following strong pressure from some major producers, the domestic monopoly has been abandoned and there have been consequential minor adjustments to the Board's legislation. Interestingly, the Board has had little success in obtaining entry to the Australian market, blaming quarantine restrictions. More likely, and taking a line from the kiwifruit experience, it would be doubtful if, under CER, it could maintain single desk seller status to Australia.

A year ago, a further amendment was made enabling any firm which thought it could demonstrate an export capability to argue its case to the Board. However, this was a Clayton's liberalisation because the Board would be acting in the role of competitor, judge and jury - with all relevant confidential market information being divulged to it. Not surprisingly, there have been few applicants and no approvals yet.

Kiwifruit

The kiwifruit industry is a relative newcomer to the statutory marketing family, the New Zealand Kiwifruit Marketing Board only commencing in 1989. Kiwifruit itself, of course, is also a new industry, with production increasing from almost nothing twenty years ago to over 300,000 tonnes now. Before last season's market downturn, New Zealand kiwifruit exports were significantly higher than apples.

However, in its short existence the Board has managed to become embroiled in a fearful mess, as it and growers have misinterpreted market developments and pursued the misguided notion of maximising farmgate returns rather than industry profitability. The industry has failed to appreciate that New Zealand no longer has any exploitable market power internationally, as kiwifruit production in Italy, Chile and elsewhere has grown apace. As a result, marketing costs, anti-dumping duties in the United States, and losses from the forced processing of allegedly unsaleable (actually, non price premium) fruit have dragged down industry returns.

The government's response has been reactive and politically motivated, and it will ultimately prove to be ineffective. As part of a staged review of the industry, the minister established a new 38-member grower body. Then, he appointed a steering committee to provide guidance to the grower forum and tasked it with evaluating options to "maximise the profitability of those in the industry and the net benefits to New Zealand". Third, the minister commissioned researchers from Auckland University's economics department to undertake and submit research to the steering committee.[2]

The Auckland group's report has recently been released and has been widely criticised as unprofessional and shallow. Three of the five members of the steering committee, which had no say in the commissioning of the Auckland research, wrote to the minister saying its results were unacceptable. Their views were rejected.

Meanwhile, a further NZBR-commissioned ACIL report was lobbed into the ring.[3] It reiterated ACIL's earlier views that there was no alternative to confronting fundamental issues, and nothing unique in kiwifruit to justify single desk export selling, and gave several case studies from other industries to demonstrate that a more competitive approach had not led to the end of civilisation - in fact, the industries concerned had benefited.

The debacle continues. Despite the existence of a ginger group of growers opposed to the Kiwifruit Marketing Board's operations, despite the obvious contradiction in Agriculture Minister Falloon's approach to that which he is taking in the case of meat and wool, and despite the continuing poor grower incomes, it is just possible that the present arrangements will stagger on for another year or two. However, eventually they will have to be terminated, even if it may take competition from Chilean kiwifruit to be the catalyst. That would be the ultimate humiliation.

Dairy

The dairy industry is New Zealand's second largest rural industry after meat and the Dairy Board has been long regarded as a powerful and effective lobbyist in promoting its own interests. Its arrogance was well demonstrated by its initial attempt to ignore or dismiss the ACIL report - certainly not to debate it on the merits.

However, the dairy debate is now alive and well. Tensions are emerging between key industry players to the point where far-reaching reform is virtually assured. The reason is simple: milk production keeps rising because the farmgate price - which includes both an average milk return plus the return from the industry's vast off-farm investments - provides the incentive to do so, even if the market does not. Sheep farms, especially in the South Island, are continuing to be converted to dairy farms, and existing dairy farms are expanding their output, sometimes by up to 20 percent.

Yet each additional litre of milk has to be sold on less and less remunerative export markets and, increasingly, industry leaders are questioning where the capital to increase processing capacity will come from. Two years after the ACIL report, everyone in the dairy industry acknowledges that bundling is a significant issue. So far, attempts have been made to slow down production growth, for example by introducing a significant entry price for new producers. This will merely add yet a further layer of distortion.

There is now considerable tension between the Dairy Board and the New Zealand Dairy Group (New Zealand's largest dairy cooperative); essentially a tussle over which of them is the tail and which is the dog. This is given added piquancy in that the

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2 R. Brookes, W. Cartwright and M. Domney (1994), *Kiwifruit Marketing Review*, October 1994.

3 ACIL (1994), *Restoring Kiwifruit Profitability: Choice, Ideas, Innovation and Growth*, September 1994.

chairman of each is on the board of the other. The New Zealand Dairy Group can see what needs to be done, and has now reached a size where it is confident that its own expertise and brands do not need a single seller exporter to survive in the world market.

The more astute dairy farmers can also see that historical structures are not only unsustainable but will actually damage New Zealand's longer-term export prospects. So can a number of politicians, although whether they possess the courage to push reform, especially with a crucial election looming, remains to be seen.

Ultimately, the forces of economic gravity will prevail. Sometime within the next 2 - 5 years, the Dairy Board will be corporatised, single desk selling will be abolished, returns to dairy farmers will be unbundled, farmers will be given tradeable shares in the new entities, and an even stronger, more efficient and more competitive dairy industry will then be possible.

Assessment of the New Zealand Debate

The agricultural marketing debate has come a long way in the two years since the ACIL report was published. While ACIL's specific recommendations have yet to be implemented in full, the direction of reform in all five industries, led by wool, has been set and progress will prove inexorable.

For this, ACIL cannot, of course, claim full credit and in many respects we have merely collated the evidence and presented it consistently. However, I would say that, in doing so, we have done much more than just a descriptive job. Some of the insights - especially about bundling - some of the empirics - even if with only back-of-the-envelope accuracy - much of the advocacy - especially via speeches - and all of the anecdotes and case studies, have been influential in shaping opinion and shifting debate.

The climate in which these issues are being considered, of course, is favourable. The liberalising economy, the daily success stories, the growing confidence, the cultural and attitudinal changes in New Zealand - all these have made for fertile territory. The key New Zealand farm leaders who have championed the questioning of the status quo, often at some personal cost, deserve particular credit. And so too does our client, the New Zealand Business Roundtable, again in the face of considerable flak, for recognising the need for debate and having the persistence to engage in it.

Implications for Australia

There are, of course, many parallels and lessons for Australia. A more aggressive, entrepreneurial and successful New Zealand agricultural marketing and processing sector obviously poses severe competitive challenges for Australia. After all, that is what competitiveness is about: the race without a finishing line. We may be ahead in certain areas, but there can be no room whatsoever for complacency.

Second, much of the analysis, certainly the broad principles, is relevant here. For example, this year the market failure logic has been applied systematically and effectively to the regulatory arrangements for the meat and livestock industry. In time, it will be extended further - to dairy, to further reforms with wool (especially to prevent the re-emergence of regulatory intervention as the wool stockpile is sold for better-than-expected prices), to various state-based statutory marketing arrangements and, the big daddy of them all, to export wheat marketing.

To conclude, let me apply the principles to a very topical issue, the cotton trash contamination problem with beef. I have no doubt that, to many people, this regrettable incident is powerful ammunition in arguing for the continuing need for a strong regulatory approach and a reassuring industry body - the AMLC - to convince overseas customers that all is well.

To me, the real lesson to be learnt is exactly the opposite. There are, I think, three key points:

- first and foremost, if our existing regulatory apparatus did not pick up this problem at an early stage, why would any additional regulation or regulators do the job? As one of my colleagues has observed, this is the Humpty Dumpty solution, thinking that still more horses and men are needed to put Humpty Dumpty back together again;

- second, I cannot think of a better demonstration of the futility of the 'Aussie beef' approach to export marketing - one consignment is suspect, so all production from the country is under a cloud. Contrast this with the example a few years back when Perrier mineral water had to be withdrawn from the retail shelves for several weeks because of some contaminant. Perrier's problem, which it quickly corrected, did not queer the patch for other brands; and

- third, we will never solve these types of problems properly until ultimate responsibility lies in the correct place - with producers. Once they have to provide guarantees for their performance and bear the financial costs of deficiencies, the mind-set changes mighty fast. It is happening now with footrot in sheep; why not with pesticides in drought fodder?

So I sincerely trust no one thinks that the issue can become a lifebuoy to which an old-style AMLC can cling for survival. If it does, then this will be yet another factor bringing the New Zealand dollar towards parity with the Australian dollar.

EDUCATION AND THE LABOUR MARKET

H R NICHOLLS SOCIETY

BACK TO BASICS ON THE LABOUR MARKET

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

MELBOURNE
22 AUGUST 1995

BACK TO BASICS ON THE LABOUR MARKET

Behind most of the great public policy debates in Australia and New Zealand has been a set of ideas that were deeply embedded in the public consciousness, in some cases for generations. Thus policies of import protection, for example, were based on the idea that the rest of the world did not treat us fairly; that we could not match low wage/high technology competition from abroad; that industrialisation was dependent on shutting out competing imports; that protection was necessary to regulate the balance of payments; that protection created jobs; and so forth.

All these justifications for protection were completely wrong, but they were part of the conventional wisdom which shaped official policy for decades, to our very great economic cost. It took most of the 1970s and '80s in both our countries to dissect these arguments, expose the fallacies, and build the consensus in favour of the open economy stance that is now firmly established.

So too with the labour market. For most of the last century, the Fabian socialist idea that labour was "different" held sway. In the rhetoric of the time, labour, it was said, was "not a commodity;" there was "unequal bargaining power" between employers and employees; and, as a consequence, "wages should be taken out of competition." These ideas lay at the heart of the development of collectivist approaches to labour relations and moves to put trade unions outside the law. On the basis of them, an edifice of byzantine complexity was built to regulate one of the most routine functions in life, namely getting a job.

At its most fundamental level, the labour market debate in New Zealand in the 1980s involved confronting the Marxist-Fabian ideas and identifying what was wrong with them. In the end, commonsense prevailed and a framework for employment relations founded, broadly speaking, on principles of freedom of contract was established with the Employment Contracts Act of 1991. Regretfully, that position has not yet been reached in Australia. And while enterprises, workers and, indeed, many unions have got on with the job of constructing much more productive and cooperative working relations, it has to be said that traces of the old ideological baggage can still be found. The main instances are in quarters remote from the practical world of work, such as the bureaucracy (especially the Department of Labour), the courts, and the universities. Thus just this month a labour law academic at Canterbury University described the idea that there is no systematic inequality in bargaining power between employers and employees as "breathtakingly fatuous." It was an eloquent testimony to Adam Smith's opinion of universities as:

> ... sanctuaries in which exploded systems and obsolete prejudices found shelter and protection, after they have been hunted out of every other corner of the world.

There is really no excuse for this kind of error after all the scholarship that has been brought to bear on the Fabian beliefs. It is true that much of labour economics is a desert. But as far back as the 1930s, Bill Hutt, arguably this century's most under-appreciated economist, was painstakingly exposing the myths in his writings on collective bargaining (and incidentally criticising Keynesian ideas as well). In the United States, Don Heldman, James Bennett and Manuel Johnson in *Deregulating Labour Relations,* Morgan Reynolds in *Making America Poorer: The Cost of Labor Law*, and Howard Dickman in *Industrial Democracy in America : Ideological Origins of National Labor Relations Policy* have given a comprehensive treatment of the issues. In New Zealand a similar exposition is available in Penelope Brook's *Freedom at Work : The Case for Reforming Labour Law in New Zealand*, and Gerald Garvey's work for the Business Council in Australia and his book *The Market for Employment* reflect the same insights of modern scholarship. Some of the very best contemporary writing on the subject comes from the giants of law and economics scholarship, Richard Posner and Richard Epstein, but their work, as yet, seems barely to have penetrated courts and law schools, at least in New Zealand .

Once the veil of the Fabian rhetoric is pierced, it is not difficult to dissect the standard arguments and expose the flaws. The starting point is the belief that employers, particularly large employers, are in a position of dominance in their relations with individual workers. The employer is said to have considerable resources while the worker has few "reserves." Therefore employers, the argument goes, will dictate the terms of the contract unless "countervailing power" is provided through monopoly unions and collective bargaining to redress the unequal position of workers and prevent exploitation.

To understand what is wrong with this familiar position, it is useful to start with some analogies. A situation in which individuals with few resources deal with economic entities with greater resources is not unique to the labour market. A consumer shopping at a large department store usually has no ability at all to bargain over the price of an item on display or the terms of sale; the choice is to take it or leave it. But provided the retailing market is competitive, we do not regard the consumer as open to exploitation or in need of a consumer union and collective purchasing. The strongest protection available to the consumer is the option of going to the shop next door. Similarly, standard form contracts for products like insurance, which were once frowned upon by the courts, are no longer seen as anti-competitive and biased against consumers.

Or consider the position of a small saver dealing with a giant financial institution, say a bank. The saver wants the highest interest rate for her deposit; the bank wants to pay the lowest amount possible. However, it also wants to attract the deposit. If it doesn't offer a competitive rate, the saver will go elsewhere. Competitive financial markets, not a union of savers, are the saver's best friend.

It is worth noting that small consumers and small savers do not have to be highly educated or experienced to be protected against exploitation. In competitive markets the most naive and ill-informed school leaver, for example, enjoys the protection provided by other players who determine, at the margin, the conditions of trade. Banks may deplore the idea of having to pay more for their deposits if demand for funds exceeds their supply, but even though they have vastly more resources than their individual depositors there is nothing they can do about it other than offer savers a better deal.

Exactly the same reasoning applies to the market for labour. As Epstein puts it:

> The argument about exploitation is surely no stronger when cast in the analogous language of inequality of bargaining power. Thus assume that an employer could "dictate" the terms of trade in the marketplace. What would we expect to see the contract look like? The answer is that the employer would never stop pressing her advantage. If it turned out that the employer could dictate terms, why would she offer a wage of 10 if she could drive it down to 9; and why would she settle for 9 if she could drive it down to 8? The logic of dictation leaves the employer no reason to stop until, without mercy, she has extracted the last bit of advantage. When the process comes to a halt, we should observe people working for employers at a zero wage, and we don't. If firms can exploit workers, then retailers can exploit their customers, so that it is unnecessary to offer cash discounts, free exchange privileges, and volume discounts. Start with these oft-repeated assumptions, and there is no stable or discernible equilibrium with wages or, for that matter, prices in any relevant market. Yet the theory of exploitation notwithstanding, we have long observed positive wages for labor and finite prices for goods. ... The idea of inequality of

> bargaining power, the idea of dictation, fails the most decisive test: it has no *descriptive* power.

The basic intuition about contracts, at least within the framework of a market system, is that they will not occur unless both parties are better off. The resources of the two parties may be highly unequal before the transaction takes place, but both see the opportunity of making gains from trade. Labour markets are not 'unique' in having 'size' imbalances between buyers and sellers, and in the absence of statutory restrictions they are characterised by relatively mild problems of market power. There are large numbers on each side of the market, and annual job turnover amounts to a significant fraction of the labour force. For the same kind of labour, the largest firm in the land has to pay as much as the smallest employer. Moreover, where market power is detected (for example in some public sector settings) the appropriate response is to support or enhance competition, not to compound the problem by enforcing monopoly unionism on the other side of the market.

At its base, the Fabian argument is a misunderstanding of how markets work and how prices are set in them. Employers are not in competition with workers, which was the idea behind the adversarial system. Employers are in competition with other employers for workers, and employees compete with other employees for jobs. The result of that competition in open markets determines wages and other conditions of employment. As in all markets, there may sometimes be a margin or element of 'rent' that may be bargained over, either individually or collectively. But essentially it is the availability of higher valued alternatives, not the ability to bargain collectively, that increases bargaining power. An employer who faces competition for staff simply cannot afford to indulge prejudices, mistreat workers or hold down pay. An employee who can go elsewhere is a very difficult worker to exploit.

This is true even where there is unemployment. But to say that there is no systematic or long-run inequality in bargaining power is not to deny that labour markets, like any other, may favour either buyers or sellers at particular times. In New Zealand in recent years there has been a glut in the commercial property market. Rentals fell or were depressed for some time, until new entrants were attracted into the market by the more favourable terms and space was taken up with rising economic activity. Now rentals are rising, not across the board but where shortages of the types of property in demand are showing up. What was a buyer's market is now becoming a seller's market again.

Exactly the same adjustments must occur in labour markets if they are to clear. Wages stayed flat in New Zealand while unemployment was high, but they are now rising in areas where skills are short. There is no long-run bias in favour of buyers of labour. Over time, we can see clearly that it is not returns to capital that go up; in the last seventy years, the real long-term risk-free rate of interest in the United States has generally fluctuated in the 0-2 percent range. What goes up is the stock of capital and consequently wages, or returns to labour generally, as workers have more capital to work with and skill levels improve with investments in education and training.

Other strands in the Fabian argument can be disposed of briefly. The slogan that labour is not a commodity does not withstand analysis. All markets involve human beings. Labour markets are not about selling people; there are rightly laws against all forms of involuntary servitude. Rather, they are about selling labour services, because most people both want and need to work. As Adam Smith put it:

> The property which every man has in his own labour, as it is the original foundation of all other property, so is the most sacred and inviolable. The patrimony of the poor man lies in the strength and dexterity of his hands; and to hinder him from employing this strength and dexterity in what manner he thinks proper and without injury to his neighbour is a plain violation of this

> most sacred property. It is a manifest encroachment upon the just liberty both of the workman and those who might be disposed to employ him. As it hinders the one from working at what he thinks proper, so it hinders the others from employing whom they think proper.

Labour services are not different from other goods and services in any economic or moral respect that removes them from the scope of conventional economic analysis. Almost everyone is willing to trade labour; the only question is what are the terms on which it will be traded. If the terms are not to be set by voluntary contracts between employers and employees in competitive markets, the only alternative is for them to be set in markets which are regulated through political or judicial processes. Because such processes can never reflect the highly individualised preferences of workers and the needs of individual workplaces, they end up mandating uniform, one-size-fits-all, employment terms. The inevitable results, as we are all too well aware, are acrimony and friction, increased transaction costs, and massive economic inefficiency. A politically-determined structure of wages and conditions usually leaves large numbers unemployed, denies young people the opportunity to obtain work experience and training, and reduces the growth potential of the economy.

Indeed it was the regulatory scheme that arose from the Fabian prescription which, ironically, turned workers into commodities through uniform pay rates under blanket national awards, and turned unions into commodity traders. As Garvey has put it, the message that individual free choice is the best policy for both sides of the labour market is amplified by recognising the uncertainties, complexities, and long-term nature of many employment relationships. It is the collectivist approach that understates the complexities, uncertainties, and importance of the labour exchange process, and that facilitates the exercise of capricious power over the fate of individuals.

Admittedly, it is possible to make slightly more sense of the Fabian arguments in the labour market settings of 19th century Britain. In those days, worker mobility was much more limited, with many people spending their entire lives within a few miles of where they were born. The one-factory town was not unusual, standards of literacy were low and information was not abundant and cheap. None of those conditions applies today. If worker exploitation were still a routine phenomenon, we should expect to find it in countries like present-day Hong Kong, which has perhaps the freest labour market in the world with no minimum wages and negligible union involvement in bargaining. Yet per capita incomes in Hong Kong have outstripped those in both Australia and New Zealand. Even more ironically, Hong Kong manufacturers are now contracting out work to 'cheap labour' countries. A recent issue of *Asia Inc.* quotes Warwick Meyers, a leading Hong Kong tailor, as saying he can get his suits cut at a better price in Brisbane these days than he can in Kowloon.

All these conclusions were put to the test in New Zealand with the passage of the Employment Contracts Act. The Act is based on a recognition that workers and employers share a common interest, and that employment contracts depend for their existence on making both better off. It has no bias against trade unions or collective bargaining but it gives no privileged position to either. The Business Roundtable's submission on the draft legislation saw it as a vast improvement on the previous regulatory structures. It said that:

> Once it is clear that the old hidebound ways of doing business will only result in mutual ruination, they will soon pass from the scene. Most employers and employees will quickly adapt to the change in circumstances. They will adjust their behaviour to the new legal environment in which production and competition count for far more than the tightly defended privileges and relativities by which New Zealand labour has been hamstrung for so long.

Opponents of the legislation, on the other hand, predicted industrial mayhem. In line with the Fabian analysis, they foresaw worker exploitation and general reductions in wages and conditions of employment. When those things didn't happen, they predicted wages would 'blow out' as soon as the economy was seen to be growing strongly. When a wage blow-out didn't happen either, they said workers were missing out on the banquet, even though tens of thousands of them were finding new jobs and pay rates were being bid up in areas where skills were in short supply.

The key objective of the ECA is to promote an efficient labour market. The evidence to date is that the Act has:

- significantly improved the productivity of labour and capital through more flexible working arrangements and the removal of many restrictive work practices, and boosted international competitiveness;

- greatly improved the climate in the workplace, encouraging far more trust and communication between firms and their staff;

- led to a marked reduction in industrial disruption;

- seen a fall in union membership from around 45 percent of the workforce to around 25 percent, although some unions which adapted quickly have increased their membership;

- contributed to macroeconomic stability, allowing inflation to be kept in check while unemployment has continued to fall;

- helped maintain real wages. Even when the economy was in a protracted recession, real wages on average fell only slightly and the outlook is for increasing real wages as the slack in the labour market is taken up;

- encouraged an increase in wage dispersion, with a larger premium being paid for skills; and

- greatly boosted employment growth, as unemployed 'outsiders' became more able to compete for jobs. Employment is at an all-time high, and full-time employment has been growing faster than part-time employment. The unemployment rate has fallen from a peak of nearly 11 percent of the labour force in the September quarter of 1991 to 6.3 percent today. New Zealand now has the third lowest level of unemployment in the OECD. Maori, Polynesian, youth and long-term unemployment rates have fallen even faster, although they remain above the average.

The ECA was introduced in the middle of 1991, which roughly coincided with the trough of the last recession. Since then the economy has grown continuously. Output has risen cumulatively by 15 percent in the last three years. Inflation appears to have peaked at an underlying rate of just over 2 percent, with the economy still growing by around 3 percent this year and poised to accelerate again. The new economic framework has proved robust through a full cycle; the boom/bust pattern which characterised the New Zealand economy for years appears to have been broken.

The labour market outlook is still favourable. Unemployment in the European population is now down to around 5 percent of the labour force, which some regard as approaching a floor. I believe this view is mistaken, and think that unemployment will fall much further yet. In a report for the Business Roundtable in 1994, Judith Sloan predicted that total unemployment would fall to 4 percent in the next four years, and we are well on track to such an achievement. Progress would be hastened by more efforts to improve labour market flexibility, increase skills and reduce welfare disincentives.

Attitudes towards the ECA have slowly become more favourable. Initially most people seemed to think the Act was good for the economy but not for them. A recent poll indicated that 77 percent of respondents thought it was good for them or made no difference, but a majority nevertheless disapproved of it. Just as high levels of unemployment often did not seem to count against governments around the world in the 1970s and '80s, perhaps because most people stayed employed and were unaffected, most New Zealanders may still be feeling that the ECA has not improved their own position. In a direct sense that is partly true as the benefits to date have gone primarily to those previously unemployed, who are fewer in number and who may not recognise the link between the freer labour market and the fact that they have now got a job. Moreover, the ideological attachments to the former view of labour relations are deep-rooted and can only be expected to change slowly. It may take several more years of falling unemployment and rising wages for support to become consolidated. Whether that happens will, in part, depend on political developments. The government and several of the new parties are committed to the present legislation while Labour and the Alliance have promised to modify it to varying degrees.

How much progress New Zealand has made towards a more efficient labour market therefore remains somewhat in the balance. Certainly the achievement is far from complete. Although the Fabian model has been discredited in many respects, it still influences New Zealand thinking. Epstein has pointed out that a litmus test of its continuing influence around the world is the existence of minimum wage legislation and mandated unjust dismissal rules, and New Zealand fails the test on both counts.

Last year the Business Roundtable published a detailed study which found that our statutory minimum wage was costing New Zealand several thousand jobs, particularly among young and unskilled workers, as well as having other negative effects ranging from reduced training to discrimination. The findings were entirely in line with many overseas studies. Few issues in economics attract a greater consensus than the harmful effects of minimum wage laws. Yet the response to the report, particularly among those who claim to represent the interests of the under-privileged, was a deafening silence. Even though many OECD and Asian countries have no minimum wages, there is as yet no significant constituency for their removal in New Zealand. The Fabian idea that wages should be "taken out of competition" lives on, with the result that marginal workers are denied the opportunity to get an initial foothold on the earnings ladder.

Similarly the Department of Labour in New Zealand has advocated legislated job security provisions for workers "who have little or no bargaining power in the labour market and who are unlikely therefore to be able to insist on personal grievance procedures in their contracts." However, if such unequal power existed in reality, wages would be driven down to zero levels, as noted earlier, and workers would surely be unable to retain their existing right to quit at will. No such circumstances can be found. In his standard law and economics textbook, Richard Posner has dealt with this issue comprehensively:

> One piece of evidence that job security is not really efficient is that outside of the unionised sector (which now employs less than 20 percent of the nation's labor force), and government employment (where tenure is a protection against politically motivated discharges - the "spoils system"), employment at will is the usual form of labor contract. The worker can quit when he wants; the employer can fire the employee when the employer wants. It might seem that this would leave the employee totally at the employer's mercy, but this is not true. If the employer gets a reputation for arbitrarily discharging employees he will have to pay new employees a premium. ... It is hard to see how workers in

> general can benefit from [a requirement of showing good cause for firing a worker]. If the requirement were optimal it would be negotiated voluntarily; there do not seem to be the sort of information problems that might defeat transactions over workplace safety. If such a requirement is not negotiated voluntarily, presumably this is because the cost to the employer of showing good cause for getting rid of an incompetent employee is greater than the benefit to the worker of being thus insured against an unjust discharge. The extra cost is a labor cost and will thus reduce the amount that the employer can pay in wages, in just the same way that increasing the employer's social security tax reduces (at least in the long run) the wage the employer will pay.

Elsewhere, Posner has explained that:

> Employment at will is a corollary of freedom of contract, and freedom of contract is a social policy with a host of economic and social justifications ... . Employment at will happens to be the logical terminus on the road that begins with slavery and makes intermediate stops at serfdom, indentured servitude, forced servitude and guild restrictions. That should be a point in its favour.

In other words, restrictions on job termination, unless they are freely written into contracts, inevitably raise employment barriers, particularly to the most marginal workers. Employers will be less willing to employ 'unknown quantities' - such as long-term unemployed workers - if it is difficult to terminate relationships that do not work out. Any increase in job security for some comes at the expense of reduced job security for others - as usual, there is no 'free lunch.'

New Zealand courts, still labouring under the Fabian notions of bargaining power and apparently oblivious to the economic analysis underlying the ECA, are handing down an appalling series of decisions on redundancy and dismissal cases. I am aware that similar trends in Australia are being strongly challenged. The judges no doubt believe that their stance is pro-worker but in reality it is nothing of the kind. While individual employers or owners of capital will be disadvantaged by an adverse decision, owners of capital as a group will not be worse off in the long run. They will adjust their decisions to ensure they achieve competitive returns on their investment. They will respond to higher costs and risks of employment by lowering wages and/or other employment conditions, by engaging in more capital intensive activities, by expanding overtime rather than hiring more staff, by investing overseas instead of in New Zealand, and by other means. Firms will have no choice but to make these adjustments to remain viable. While individual workers may gain as a result of court interventions, the losers will overwhelmingly be workers as a group and the unemployed.

If New Zealand is to complete the process of creating an efficient labour market, we shall have to recognise that our approach to job security issues remains flawed. Getting, keeping and changing a job is part of the ordinary stuff of life. People who are regarded as competent to vote, marry and raise a family should not be regarded as incompetent to work out their employment contracts without extensive third party involvement. Employment contracts involve personal relationships that have many features in common with other personal relationships such as marriage contracts. Some employment relationships, like some marriages, do not work out. For good reason, we do not insist on personal grievance rules, involving both procedural and substantive concepts of fairness, being applied to the termination of a marriage. A no-fault standard for divorce is judged sensible, even though it may be unfair in some cases. In the same way, as Epstein has written:

> Labour markets will always have their short-term casualties. There is no way you can run a system error-free. But it is an absolute delusion to think you can stop these errors by introducing a legal standard of unjust dismissal, which, even after the enormous amount of articulation within the legislature and courts, comes down to the question of whether or not this dismissal was 'reasonable under all the circumstances': a test that is profoundly useless with respect to the thousands of different circumstances to which it is said to apply. By spending enormous sums of money to decide the outcome of a particular case, the law diverts much wealth from productive investments in capital and labour, investments that could expand the total amount of social opportunities available for everybody. ...
>
> That being so, the best protection for individual workers is not the ability to sue an employer but rather to say: if I have been wrongfully dismissed from one job, I will be able quickly to find another. Yet this will not be too common an occurrence, since the employer will have to pay for his error through lost reputation. Open labour markets are the greatest protection against individual injustice.

If we in New Zealand and, I trust, Australia in the not-too-distant future, can absorb that lesson we will have put behind us for good the impoverishing Fabian legacy and, as another American scholar and statesman once put it, "closed the circle of our felicities."

SOUTH ISLAND CONFERENCE OF DEPUTY AND ASSISTANT PRINCIPALS

STUDENTS AT HEART

ROGER KERR
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CHRISTCHURCH
22 APRIL 1995

STUDENTS AT HEART

I am delighted to be speaking to a conference with the title 'Students at Heart.' One thing we have learnt in the last ten years is that, in any successful enterprise, customers come first. It is not always an easy lesson, either in business or in education. I recall the observation of George Stigler, one of the best writers in economics as well as being a Nobel laureate. When someone mentioned to him the legendary image of Mark Hopkins sitting on a log, talking to a student on the other end, Stigler remarked:

> Sometimes you could do just as well sitting on the student and talking to the log.

I regard teaching, with all its frustrations, as the premier vocation. Education is ultimately the transmission of civilisation, the best that has been known and thought in the world. For me there is no better encapsulation of the essence of civilisation than the famous passage at the end of Kenneth Clark's book of the same name:

> At this point I reveal myself in my true colours, as a stick-in-the-mud. I hold a number of beliefs that have been repudiated by the liveliest intellects of our time. I believe that order is better than chaos, creation better than destruction. I prefer gentleness to violence, forgiveness to vendetta. On the whole I think that knowledge is preferable to ignorance, and I am sure that human sympathy is more valuable than ideology. ... I also hold one or two beliefs that are more difficult to put shortly. For example, I believe in courtesy, the ritual by which we avoid hurting other people's feelings by satisfying our own egos. ... Above all, I believe in the god-given genius of certain individuals, and I value a society that makes their existence possible.

Clark ended his book by talking about confidence. Lack of confidence, he said, more than anything else, kills a civilisation. It is easy to see what he meant. For much of the last thirty years it was hard to be hopeful about New Zealand. We could never compete in the world, we were told. The rest of the world did not treat us fairly. The electorate would never support governments that took the longer view and dealt seriously with our problems rather than just tinker with them. The most we could hope for, it seemed, was a steady slide into mediocrity. No wonder many of the best and brightest left for other shores.

All that has now changed beyond recognition. New Zealand is now a far more hopeful place than many parts of the world. There has been a stunning economic turnaround. By the end of this year New Zealanders will be producing 20 percent more goods and services than they did five years ago. Within five years that figure is likely to have risen to 50 percent. Record numbers of jobs are being created and unemployment is now down to two thirds of the level it was at only three years ago. Certainly there remains plenty to be done to help those who are still struggling. But for now, New Zealand has become a top-performing economy. We are starting to share the optimism and dynamism of the fast-growing regions of Asia.

To be sure, there are still some who deny the success and predict growing poverty and inequality. But we only have to look to Asia to know that sustained economic progress is a tide that lifts all boats. We know how to solve those problems - the answers are primarily savings, investment, jobs and skills.

There are other reasons why young people coming through schools should feel more optimistic about the future. Thanks to Western firmness, the Cold War is over and the communist regimes that were the greatest threat to world peace are no more. While there are still dangers, children don't need to stay awake at night dreading a nuclear winter. Democracy and freedom are spreading around the world.

More and more countries are discovering the secret of wealth creation through market economies. The outlook for the world economy is the best for years. The food and energy shortages much feared in the 1970s have not come to pass and are unlikely to do so. The environmental scares of the 1980s - from alar to acid rain - have mostly turned out to be bogus or exaggerated. Even global warming, the mother of them all, is now less certain and unlikely to be apocalyptic even if it is occurring. We know how to achieve both material progress and environmental protection.

The idea that many of our students would have to prepare themselves for a life of unemployment, which was being promoted by educationists like Jack Shallcrass only a few years ago, is nonsense. So too is the idea that the only jobs going today are those for the academically bright. You just have to walk around a few blocks of this or any other city with your eyes open to see that there are plenty of new, rewarding jobs for people with other kinds of skill.

All this, I submit, means that our young people today have solid grounds for facing the world with confidence. To instil pessimism in students about job prospects and the like is irresponsible. It cannot help our youth suicide problem. The reality is that the coming millennium could usher in the century with the best hopes for civilisation that the world has ever known.

I do not mean for a moment to take a Pollyanna stance and deny that there are problems or threats to this outlook. They are not primarily in the economic field, however; the rules for running a successful economy are now well understood. The threats are much more in the moral and cultural domain, as writers such as Vaclav Havel and Michael Novak who recently visited New Zealand have repeatedly emphasised.

A loss of moral and cultural bearings can fatally undermine an otherwise free and prosperous society. Many have argued that education, perhaps the most important of the cultural industries, has suffered such a loss, at least in a number of western countries. For example, Professor Max Hartwell, the historian of the industrial revolution, has had this to say:

> The world of education, today, too often is characterised by uncertainty and confusion about curricula (even about the basic elements of an education - reading, writing and arithmetic); the zealotry of teachers for a variety of "relevant" causes (for example, environmentalism where much nonsense passes as knowledge); moral relativism (all values are relative and everything is as good as everything else); political correctness (which takes the form of censorship of those who disagree with current orthodoxies, and also of the stifling of free speech and discussion); the decline of the liberal arts and the ascendancy of vocational schools (typified by business schools); and the myth of certain knowledge (historicist theories, for example, about history happening "in a certain way"). Of course not all teachers and not all institutions are similarly afflicted, but anyone who has a career in education will recognise these characteristics in greater or lesser degree.

The malady is obvious; the question is: What is the remedy? It forces us to think about the qualities of a liberal education. I share the views of Hartwell and Clark that a liberal education should encourage openness and free discussion, tolerance and a willingness to confront opposing views and, above all, civility in discourse and respect for other individuals. It requires a belief in rationality in debating issues and reconciling differences. A liberal education should emphasise pluralism and complexity, and hence the impossibility of perfect knowledge. And, as Hartwell puts it:

> A liberal education is both radical and conservative: radical, in the sense that nothing is above criticism, that authority is no proof of validity, and that all propositions should be scrutinised critically; conservative in the sense that tradition should be recognised and valued as socially embedded knowledge and experience, but still subject to critical scrutiny, and that change has to be justified and not necessarily seen automatically as a good.

Recently there have been suggestions that the education debate in this country has concentrated too much on structures and institutional arrangements and not enough on content - on what students ought to learn. For reasons I shall mention shortly, I do not think the debate can be divided up in this way, but I agree it should be possible to define in reasonably concrete terms the general contours of a good education. Another historian, Paul Johnson, recently formulated what seems to me a sensible, down-to-earth account of what most ordinary people want from education:

> The demands of ordinary people are not exorbitant. They want all children to read, to read easily, accurately and sustainedly; to form, if possible, the habit of reading and acquire the taste for good literature. They want all children to be taught to write, legibly, fluently and grammatically, to acquire a reasonably wide vocabulary and to spell correctly. They want all children to be numerate and to handle proficiently the elementary instruments of a modern electronic society. Children, they think, should be taught about their country's history and geography ... and learn to value its qualities. They want children to acquire in school, reinforcing home training, habits of diligence, punctuality, neatness, cleanliness and civility. And, not least, they want the schools to provide, for all children, a moral education: to instil, not just directly and specifically, but through all the school structures and procedures, clear distinctions between right and wrong, good and evil, decent behaviour and wickedness.

I hope I have said enough about the case for a liberal education to make it clear that the business community - or at least the part of it that I represent - has no interest in turning education into narrow vocational instruction. Those talking the language of skill rather than knowledge, competence rather than excellence, and what could be called the 'commodification' of education into unit standards are not from outside in the business sector. If there are barbarians around, they are inside the gates.

There are some encouraging signs that education in New Zealand may be moving in the direction that Paul Johnson suggested ordinary people want.

One was a poll in last week's *National Business Review* which found that approval of the public school system has improved significantly in the 18 months since a comparable poll. Some 47 percent of respondents now rate the system good or better, up from only 36 percent 18 months ago.

Another interesting snapshot was a recent *Listener* review of the Tomorrow's Schools reforms. Not even the *Listener* managed to turn it into a dirge - things are looking up since the new editor took over. What stood out was the blunt talk and confidence of several principals. Some quotations:

> Standards had gone down. Now I think that's turning around. We're going back to more rigour in education than there was in the soft tree-hugging philosophies of the '70s and early '80s.
>
> Schools in poorer areas should stop blaming the government, stop blaming socio-economic status and start emphasising academic achievement ... if they have high expectations of kids, they will respond.

> Parents are not thick. They know which schools are getting academic success, or whatever success they're looking for. They vote with their feet and in my view they vote intelligently.

Despite these encouraging developments, all is clearly still not well. The *Listener* article mentioned some genuine problems, like overcrowding and truancy. The fact that 48 percent of respondents in the NBR poll rated the public school system "only fair" or "poor" is sobering. In last year's World Competitiveness Report in which New Zealand generally scored highly, we ranked only in 17th place - just one above India - on the criterion of how well the education system meets the needs of a competitive economy.

How can we do better? Most people in business today ask that question of themselves all the time, and it ought to be possible to debate the same question in education. Just as running an economy well comes down to some rather simple fundamental issues, I suspect that good education also consists of some pretty basic requirements. Everything I read suggests they include leadership by principals and senior managers, quality teachers, high expectations of students, regular assessments against those expectations, discipline and hard work.

As far as school organisation is concerned, it also seems clear that effective schools are those that enjoy a large measure of autonomy, and that the key to autonomy is school competition and parental choice.

It is here that the issue of the content of education links up with the issue of structure. Many people, perhaps most, will endorse Paul Johnson's idea of the ingredients of a good education. Others may not, and the system should cater for their needs too. There should be a place in the market for both "Tamaki progressive" and "vintage Avondale." One brand appears at the moment to be gaining market share relative to the other, but so long as some parents prefer the Tamaki brand why should their choice be denied? All of us should surely be very wary of imposing our own views on something as diverse and personalised as students' needs. I have enough trouble running my own life without wanting to run other people's as well.

Of course choice is never limitless: there aren't as many choices of doctors, restaurants and women's fashion shops in Geraldine as there are in Christchurch, and there are more again in New York. But the aim should surely be to maximise choice, within available resources. There is plenty of school choice in larger centres, and in smaller ones it can be expanded with new schools, schools within schools, new forms of distance learning, boarding and so forth, provided comparable resources are available to each.

At present there are some unnecessary restrictions on choice, and critics are right to argue that the outcomes may not always be favourable. There is still much inflexibility on the supply side - popular schools are not able to expand capacity nor can new schools be set up if the Ministry of Education thinks there is an 'under-utilised' school down the road. Imagine that principle being applied to any other service - say a medical clinic or the hotel industry. Similarly, we may be at risk of poor schools becoming worse if there are not mechanisms to deal with them a lot faster than was the case at Nga Tapuwae. The other key restriction is the uneven terms of competition between government and non-government schools. Choice would be greatly expanded by levelling the playing field.

Competition combined with the removal of government control has transformed many parts of our economy, bringing consumers better quality at lower cost for everything from airline services to telecommunications. In my view the post-Picot moves towards decentralisation and choice have been largely responsible for the improvements in education to date, but they have not gone as far as in other areas and the gains have not been as great. Contrary to many claims, I believe the evidence is overwhelmingly clear that competition is the best friend of the least well off, that most parents are not too dumb nor too uninterested to make good choices for their children, and that those who do not take a close interest in schools will be better protected under competition by those who do.

For those reasons I believe the government's prime role in education should be to protect minors from parental failure by regulating the sector where necessary, and to finance education on behalf of the community with parents and students being able to opt for either public or private providers on even terms. There is also an argument to be made that the government's financing role should be confined to ensuring access to education for those with insufficient means. This would allow tax reductions for the rest of the community which would add hundreds of millions of dollars to national income - through the high economic costs of raising taxes that would be avoided.

Further down the track we ought to be able to debate whether the government needs to own and run all schools or whether many could be better handed over to their local communities as trusts. One would have to be of an unusual ideological persuasion not to be open to examining this option on pragmatic grounds: not even Karl Marx thought the state should run schools. Tony Blair, the British Labour Party leader, has recently argued that a strong society should not be confused with a strong state. The former Swedish Under-Secretary of State for education and science, Odd Eiken, has added that if we want to reinvent civil society, we must give schools back to families.

It is important to note that options of this kind no longer have to be debated as abstract possibilities. The visit of Polly Williams a couple of years ago gave us an insight into the benefits of education vouchers for low income, minority families. Odd Eiken's visit will enable us to learn more about Sweden's experience in applying a comprehensive system of broadly equal funding to government and non-government schools. And of course there are plenty of examples of privately-run education institutions at home and abroad that we can study.

The last issue on which I wish to say a few words is that of teacher morale. It troubles me that whereas the national mood is now much more one of confidence and optimism, the mood among teachers is not. I know that is not universally the case and it is to be hoped that an improving public perception of education - provided it is soundly based - will help. But I was distressed to see a South Island principal whom I know and respect, Linda Braun, writing recently:

> Teaching was once an honoured profession but it now seems to be more fashionable to sneer at teachers for doing such a thankless and poorly rewarded job. Little wonder that we sometimes feel defensive and embattled.

What explains this problem? I don't pretend to have all the answers. Many teachers would say pay, and there may be some truth to that. However, the principles regarding teacher pay are relatively straightforward and are no different from those applying to other parts of the economy. Employers of teachers need to provide pay and other conditions sufficient to attract staff in the numbers and of the quality they require. If those requirements are not met, pay will need to be adjusted. One thing I feel is certain is that governments are no longer likely to go in for pay adjustments regardless of performance. Teaching is one of the last areas where old-style national awards still exist. I may be wrong, but unless we see changes in employment arrangements - desirably I would suggest to individual contracts like other professionals - I expect the frustration over pay will persist.

However, I suspect the explanations of the problem go much deeper than pay. Let me briefly list a few issues which I think it would be profitable to explore.

The first is the issue of teaching as a profession, which I believe it should be. The essence of a profession is service to clients. Hence the theme 'students at heart' is encouraging. Despite much lip-service, this has not always been the priority of education unions in the past.

Secondly, if education is the transmission of civilisation, then there is something to be transmitted. 'Transmit' does not mean 'facilitate'. Like Kenneth Clark I may be a stick-in-the-mud, but I believe it also means to impart knowledge and to correct mistakes. Child-centred learning has its merits, but I suggest the extremes to which it has been taken have helped devalue teaching as a profession.

Thirdly, there have in the past been attitudes in teaching which have affected community perceptions of the profession, such as a hostility to business and to making money. Most people that I know, teachers included, seem interested in making money, among other things. Most school leavers go to work in the private sector and it is bizarre that they should be conditioned in this way. For its part the business community has been trying to promote better understanding through school partnerships and the like, and I am told such attitudes are fading. If so, that's good.

Fourthly, a reason for the new-found pride and confidence among staff in many New Zealand firms is the discovery that they can foot it in competition with the best, at home and around the world. Teachers in the public school system in particular still seem to shrink from competition and regard it as a dirty word. No other profession, not even health, is now in a sheltered position. I very much doubt whether a protected profession will ever enjoy parity of esteem with others.

Fifthly, there is a disappointing engagement by the teaching profession on many academic issues of the day. In my view there are many questions to be asked, for example, about the quality of recent curriculum statements and the proposed qualifications framework. It is ironic that most of them are being asked not by teachers but by people like my colleague Michael Irwin, researchers commissioned by the Education Forum and isolated education commentators. Many teachers are involved in the implementation of these reforms but few, if any, are asking the hard, conceptual questions about their merits. Surely high quality work on such topics should be a mainstream role of the teaching profession.

This leads to my final observation, namely that teaching lacks a professional body which, among other things, could undertake such work. There is no equivalent to the societies for law and accountancy or the institute for engineering. Professional and union roles do not sit well together. Phil Raffills is one who has recently called for a professional teaching association to be established. This could go a long way towards encouraging the rest of the community to view teaching in a different light.

The starting point of these remarks was the sense of hope and optimism that most New Zealanders now justifiably have about the future, thanks largely to the economic transformation of the last ten years. We ought to be confident from our achievements in the economic field that we have the ability to deal with the other problems - ethnic, family, welfare, crime and so forth - which still confront us.

I suggested that education may also be on the turn. Certainly our young people should be approaching the 21st century in a positive and confident mood. The malaise that could still defeat us is self-inflicted. It is moral and cultural in nature, and we must look to education as a cultural industry to help deal with it. To the extent that Linda Braun is right about the community standing of those engaged in the education industry, the community as a whole, including business, must own the problem and help find remedies.

I was asked to be challenging, and I am aware that some of what I have said will be controversial for many of you. May I simply say that I believe these are topics that will and should be debated, hopefully in the spirit that Kenneth Clark advocated.

AIC CONFERENCE ON TERTIARY EDUCATION

PROMOTING EXCELLENCE IN HIGHER EDUCATION

ROGER KERR
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NEW ZEALAND BUSINESS ROUNDTABLE

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PROMOTING EXCELLENCE IN HIGHER EDUCATION

Tertiary education's contribution to economic and social development

The New Zealand economy is in better shape to deliver sustained non-inflationary growth than at any time in at least the past two decades. We could expect real GDP to expand by around 50 percent over the next ten years compared with under 18 percent between 1984 and 1994. This growth would still see us growing more slowly than the dynamic East Asian economies. We should set our sights higher.

The job of restructuring the economy is never finished and it is important that we do not stand still or, worse, go backward. If we do, the present expansion and employment growth will run out of steam and will be looked upon as an aberration rather than as a decisive break with the past.

To raise living standards further, we need to produce more goods and services which people value and produce them more efficiently. Sources of growth in real output are improved skills and aptitudes, increased investment in physical capital (such as machinery and equipment), advances in technology, and improved forms of economic organisation.

From this perspective, the education sector's prime purposes are to facilitate skill acquisition, undertake public good research and act as a storehouse of knowledge. The skills required to promote social and economic development are broad, and range from vocational skills to a deeper appreciation of the arts. Skills can be raised in a host of ways - through on-job training, learning by doing, self-managed study, and formal programmes in state and private institutions. Some economists suggest that over 20 percent of a developed country's resources are devoted to education and training in their broadest sense.

A changing environment

A strategic vision of where tertiary institutions should be heading must take account of the likely changes to the economic and social environment in which they operate.

A more flexible labour market, rapidly changing product markets and new technology will create demands for increasingly diverse skills. People will need to change and upgrade their skills throughout their working lives. These factors, together with a changing age structure, are likely to result in mature students becoming an increasingly important segment of the student population. Already more than 40 percent of students in tertiary education are over 25.

Students are also likely to be confronted with an increasing range of choices about how they will acquire the skills they need. There is growing competition among state tertiary institutions and between those institutions and senior secondary schools, on-job training and private tertiary providers. There is also competition between New Zealand and overseas universities, particularly at the post-graduate level. Competition is likely to intensify as remaining divisions between formal and informal education and training, and between tertiary and secondary education, are reduced.

For sound policy reasons, per student tertiary subsidies are set to decline progressively over the next few years. This trend will sharpen the incentives for students to demand, and providers to respond with, courses that represent value for money and are tailored to meet student needs.

Higher private contributions to direct tuition costs are likely to increase pressure for shorter, but more intense, courses. In the past, the length of courses has increased with little apparent regard for the interests of students who bear substantially higher costs by way of forgone earnings.

Technological advances will also potentially reduce the costs of tuition and facilitate linkages with overseas institutions. This will make it easier for private providers to compete with state institutions, despite the fact that private institutions are disadvantaged by funding and regulatory policies.

State tertiary institutions are likely to be subject to increased government scrutiny of their performance for two reasons.

First, the efficiency and responsiveness of formal tertiary education are critical to the achievement of the government's economic and social objectives. Substantial state funding of providers seems likely to continue over the next decade. Accordingly, the influence of fee-paying student clients, while greater than in the past, will continue to be limited. If such an important sector does not use resources efficiently, overall economic performance and social development will be impaired. State institutions therefore need to be encouraged to become as efficient as possible. Productivity improvements would help offset fee increases.

Secondly, the Crown is exposed to significant financial risk in the sector. The Crown's interest in state institutions is large, both in absolute terms and in relation to other Crown entities. The value of the Crown's equity investment in state tertiary institutions was $3.3 billion at 30 June 1994. By way of comparison, the Crown's equity investment in Crown Health Enterprises was just over $1 billion and in State-Owned Enterprises $7.2 billion. Increasing competition from alternative providers, and among state institutions, means that a greater proportion of the revenues of state tertiary institutions is contestable. More institutions are borrowing to finance capital expansion and to upgrade. In the light of these risks, ownership monitoring arrangements for state institutions are likely to be strengthened.

There is ample evidence from reforms to date in the tertiary and other sectors of the economy of the benefits of competition. In a more competitive tertiary sector, providers will be encouraged:

- to be more responsive to the needs of student clients who can choose among a wider range of competing suppliers;
- to innovate, for example to develop new courses and to modify or delete existing courses and to seek out new ways of delivering education and training. In the presence of weak competition, producers tend to argue that they are unable to conceive of better ways of meeting demand. Greater competition strengthens incentives to respond to the real wishes of consumers, for otherwise new entrants will;
- to minimise costs. Protected suppliers often argue that they are as efficient as possible and that costs cannot be cut without reducing the quality of services. This argument has been shown to be without foundation on many occasions;[1] and

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1 A detailed study of the benefits from regulatory reform affecting airlines, railroads, trucking, telecommunications, television, banking, security brokerage, petroleum and natural gas concluded that the United States gained amounts equal to a 7-9 percent improvement in the contribution of affected industries to GDP. Some net benefits could not be quantified. Most benefits accrued to consumers and, contrary to some expectations, employees and producers benefited. The facilitation of competition was a central feature of the reforms that were examined (Winston, Clifford (1993), "Economic Deregulation: Days of Reckoning for Microeconomists", *Journal of Economic Literature*, XXXI (September), pp. 1263-1289).

- to produce relevant information. Very little information is currently available on the demand for particular courses and on the delivery of education. Enhanced competition is encouraging institutions to collect and publish information that is necessary to attract students and manage their activities efficiently.

To ensure that the competitive environment stimulates maximum improvements in performance in the sector, reforms on three broad fronts are necessary:

- government funding policies that increase rewards for efficiency and quality;
- a regulatory environment that accommodates diversity; and
- a system of governance that enables state providers to respond effectively to changing requirements.

Funding issues

Tertiary funding is substantially biased in favour of state providers. Aside from TOP courses, few private providers are funded. When funding is granted to private providers (other than for TOP courses) the actual level of subsidy is substantially less than for a similar course at a state institution.

PTEs, for instance, receive a lower maximum rate of subsidy for all courses than tertiary institutions receive for their lowest cost courses (Category A and extramural courses). One reason for this is that PTEs are not funded for the capital component of courses. There is no valid justification for this practice if the capital component is intended to offset the cost of depreciation or capital maintenance. Such costs affect both state and private providers equally and they should be compensated on the same basis.

Also, because requests for funding from PTEs exceed available funding, the actual rate of subsidy provided is generally less than the maximum rate provided for PTEs. The student loan scheme is also biased against students attending PTEs as they cannot borrow the full tuition fee and they cannot receive a loan unless the PTE is EFTS-funded. This means that very few students in PTE courses are eligible for loans.

In practice, these differences result in substantial disparities in the funding received by different providers. For example, a PTE in 1994 would have received a subsidy of $2,700 per EFTS for a hairdressing course at trade certificate level. For a comparable course, a polytechnic would have received a subsidy of around $8,000.

Uncertainty concerning future funding arrangements also deters private investment in tertiary education facilities. The overall effect of existing funding policies is to reduce the ability of PTEs to compete with state institutions as they are 'crowded out' by more heavily subsidised competitors, even though they might provide better value for money.

The bias in favour of state institutions is also inequitable because it disadvantages people who pursue courses at private institutions, many of whom are from low-income backgrounds.

Neither public benefit nor equity grounds for subsidising the direct cost of tertiary tuition require that education be provided by publicly owned institutions. The question of whether public benefits arise centres on the nature of the education and training provided rather than the ownership structure of the provider. Likewise, equity issues arise in relation to the individual student's circumstances and not whether the provider is publicly or privately owned.

A more responsive and dynamic sector would be fostered by a programme to phase in neutral funding of tertiary courses offered by state and private providers, including courses at the senior secondary school level.

Under the EFTS funding system, all state providers receive a set level of funding for each class of course, based on projected enrolments. This encourages institutions to expand their rolls rather than to compete on the basis of costs and quality. Against this, higher fees paid by students (albeit often funded by income-contingent loans) have encouraged them to monitor more closely the services provided by tertiary institutions. Further benefits could be obtained by allocating a portion of EFTS tuition subsidies (currently paid to tertiary institutions) direct to students. This would encourage institutions to focus on cost and quality considerations as the basis for attracting more students.

Students in New Zealand are able to undertake multiple degrees or spend a considerable period completing a degree without incurring a penalty, other than the loss of student allowances and Study Right[2]. Although hard to measure, it is likely that the extra public benefits from each additional year of tuition decline as investment in each individual increases. Students would be encouraged to take more care over their choice of courses and would have greater incentives to perform if:

- a maximum limit were set on the number of years of full-time study which could be funded through EFTS subsidies and income contingent loans. Students studying beyond this period could fund their tuition through competitive scholarships or part-time work; and
- performance standards were introduced to retain EFTS subsidies appropriate to the course.

An appropriate regulatory environment

The regulatory environment in the tertiary sector is primarily governed by procedures for the accreditation of providers and the approval of courses.

The Education Act 1989 provides for the establishment or disestablishment of state tertiary institutions. Controls on the establishment and disestablishment of tertiary institutions are additional to the accreditation of courses and qualifications. The purpose of such regulations is unclear. They appear to be directed at regulating entry into, and exit from, most of the formal tertiary education sector and seem to duplicate, at least to some extent, accreditation requirements. The controls have the potential to restrict competition. Existing institutions are consulted on new entrants. Legislation entrenches the characteristics of tertiary institutions. These factors may restrict the development of more appropriate types of education provider.

The accreditation of providers and the approval of courses are related to the government's desire to put in place a national qualifications framework. This will provide a highly structured set of interrelated qualifications that are required to be recognised by all providers. Some of the underlying aims of the qualifications framework are commendable, such as breaking down artificial barriers between different classes of institution. However, the practicability of the NZQA's proposals is unproven and the real cost of the framework is likely to be substantial.

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2 The institution may disregard the Study Right status of students in setting fees.

The main economic rationale for the accreditation of tertiary providers is to protect the interests of consumers. It may be argued that, in the absence of government action, consumers would face excessive costs in establishing that courses meet at least prescribed standards and that qualifications awarded indicate that certain levels of attainment have been achieved. The quality of education may, for instance, be more difficult to assess than the quality of some other goods and services. Consumers can also be expected to possess less information on the quality of courses and qualifications than providers.

Accreditation may benefit employers if it provides better information than would otherwise be available about the quality of prospective employees. On the other hand, existing providers may promote accreditation requirements because some new entrants (perhaps emotively described as fly-by-night providers) might lower standards and diminish the international acceptance of qualifications awarded by existing institutions.

The present arrangements amount to mandatory accreditation because of the links between public funding and NZQA accreditation. The government needs to be clear about the purposes of accreditation - to ensure public benefits are secured or to provide consumer protection - and to align the accreditation procedures with their objectives. It also needs to decide whether the benefits of accreditation procedures outweigh the costs involved. Mandatory accreditation may give rise to one or more of the following costs:

- ***it might encourage excessive conformity.*** This impedes the responsiveness of education providers to changes in demand. Providers are required to obtain approval for courses and qualifications from accrediting agencies which tend to support conformity with the industry norm. In the case of universities, approval is required from a body comprising the provider's competitors. There is no valid reason why each provider should be required to aim at a similar quality standard to that of other providers. Most markets provide consumers with choices of goods and services which are characterised by different mixes of quality and price. Consumers and employers can be expected to require different levels of skills which a flexible education and training system should be capable of supplying. The example of the diversity of qualifications and standards among tertiary institutions in the United States illustrates that diversity need not diminish the reputations of individual institutions;

- ***it might reduce the incentive for providers to protect and develop their reputations.*** Under the qualifications framework, qualifications awarded by poorly performing organisations are required to be recognised as equal to similar qualifications conferred by other providers. This reduces the incentive for the former providers to maintain standards and impedes the establishment of independent standards by high quality institutions (through, for example, establishing brands and emphasising an institution's longevity and achievements). The fact that producers might be better informed than consumers on the quality of their services is not unique to tertiary education. That is why reputation is important;

- ***it might provide inadequate or unreliable information.*** Accreditation systems depend on reliable information about each institution's courses and qualifications which is costly to obtain. There can be no certainty that the incentives for an accrediting agency to obtain reliable information on the quality of particular courses will be strong enough to ensure appropriate and accurate information;

- ***it might impose compliance costs on providers including the direct costs of preparing submissions and supplying information.*** Indirect costs may be larger. They include the costs of delays, inappropriate courses and qualifications which satisfy the accrediting entity's requirements rather than the needs of students and employers, and the costs of lobbying the agency. The compliance and implementation costs of the national qualifications framework are likely to be substantial; and

- *it might encourage lobbying.* The value to employees of qualifications depends in part on their scarcity value. Holders of qualifications have an interest in restricting the supply of people with similar qualifications, knowledge, skills and attitudes. This helps to explain attempts by professions to control entry and to raise entry standards. Employers will seek qualifications that accurately signal to them that the employee or applicant has the ability, attributes, knowledge and skills required for entry or progression and is suitable for firm-specific training. The interests of employees and employers may differ, however, since employees can be expected to prefer generic qualifications which enable them to move among firms and industries. The interests of employee and employer organisations may also differ from those of their members for similar reasons. These conflicting interests can lead to pressure on accrediting authorities aimed at enhancing self-interest at the expense of the community.

There is no evidence that these costs of mandatory accreditation have been adequately examined in the development of the national qualifications framework and its application to the tertiary sector.

The interests of consumers would be better protected by the development of a more competitive market for tertiary education and training with responsibility for standards being primarily located with individual providers. An accreditation system should, therefore, be geared towards public benefit considerations rather than consumer protection and be less intrusive than present arrangements. Such a system would be suitable for the role of setting explicit criteria for more neutral public funding of courses by state and private providers. It should allow for greater diversity and should be based on minimum requirements that are clearly promulgated in legislation or statutory regulations.

Institutions should not be subject to compulsory requirements to give credits for qualifications obtained at other institutions and the views of competitors should not be taken into account in establishing new institutions and courses. In addition, new institutions should not be required to be structured on the same basis as the present large multi-faculty institutions. New entrants and existing institutions should be free to adopt the most efficient structure, which is likely to change over time.

Governance arrangements

In an increasingly competitive sector, governance arrangements will either impede or facilitate the ability of state institutions to respond to continuously changing requirements.

Two main approaches to future policy on governance are feasible. The first approach would be one that crystallises the current reality, namely that the government is the 'in-substance' owner of tertiary institutions. The institutions should, therefore, be accountable to taxpayers and the electorate for their academic and financial performance. Under this model there is logic in the government looking to have more influence over tertiary institutions, for example through its own appointments to councils and more rigorous monitoring of performance.

Under the second model, institutions would evolve over time to a position where they owned all their assets, determined their own governance arrangements and were basically free to make all management, employment, financing and academic decisions.

The government would retain a financing role (for tuition subsidies and research) and perhaps some regulatory role.

Under either approach academic freedom and institutional autonomy would be preserved by virtue of section 161 of the Education Act 1989. Arguably, however, they would be better safeguarded in the longer term under the second 'non-government' model. The non-government model also potentially confers on institutions greater flexibility to respond to changing requirements in a competitive environment.

If the first model were adopted and the government pursued improved accountability arrangements, they would be likely to include:

- *a capital charging and funding regime.* This would sharpen the incentives for institutions to optimise the use of the resources they control. The absence of a capital charge is likely to have led to unjustified investment in land, buildings and equipment because the opportunity cost of capital is not required to be taken into account. Some of these costs will have been borne by students through their contribution to tuition revenues. The absence of a capital charge also confers a competitive advantage on state providers;

- *an improved ownership monitoring regime.* This would help ensure better use of resources in the tertiary sector. Such regimes are in place in other parts of the state sector and appear to be working well; and

- *stronger and clearer duties and obligations of governing councils.* The legislative obligations on councils concerning efficiency and accountability are less well specified than those regarding charters, educational objectives, staff and community involvement, and academic freedom.

If clearer and more robust parameters that define accountability are put in place, institutions could be offered more freedom to operate within them. This might include greater discretion over the use of inputs, including the ability to borrow, lease or sell assets. However, evidence from the capital charging debate and the regular tug of war over annual funding suggests that the path to a stronger monitoring regime might be a rocky one. Difficult issues arise, such as whether third parties have sufficient information and strong enough incentives to do an adequate job of evaluating performance. Unique aspects of state tertiary institutions mean that they fit uncomfortably within standard corporate governance and accountability regimes for crown entities. Determining residual stakeholders (i.e. the persons or entities that receive any surplus after all other claims have been met) in state institutions is often difficult. It is especially problematical where the local community or other benefactors have been significant contributors to an institution.

In contrast, self-governing institutions operating in a competitive environment might be more flexible and responsive to changing requirements. The potential benefits and feasibility of self-governing tertiary institutions should therefore be examined. Central issues would include who the stakeholders in self-governing institutions might be and how the institutions might be set up. Stakeholders might include members of faculty, alumni, and the local community. Institutions could be set up as trusts or in some other incorporated form. Much more work would need to be done to examine these and other options. However, the fact that several state institutions already manage substantial funding from non-state sources suggests that moving towards self-government could be feasible.

If an appropriate model for self-government could be devised, it raises exciting possibilities for achieving a stronger and more dynamic tertiary sector. Such a long-term strategic goal may also make more immediate reforms easier to contemplate. Any new monitoring and accountability regimes could be seen as intermediate steps toward the self-government model by providing greater latitude to tertiary institutions in the short term. Demonstrable improvements in governance and management would assure the government that tertiary institutions were capable of handling the responsibility for self-government. Likewise, a more neutral funding and regulatory environment could be seen as a prerequisite for establishing self-governing institutions. Enhanced competition would ensure that independent institutions remained responsive to the changing needs for knowledge and skill acquisition and research.

Moving in the direction of self-management raises many of the same difficulties that will be faced under continued crown ownership, such as determining residual stakeholders. However, the potential benefits of self-government could justify efforts to resolve these difficulties.

Conclusion

A well organised and dynamic formal tertiary sector has an important role to play in contributing to the goal of a growing and responsive economy and the enrichment of diverse cultural values. Continuous evaluation of the performance of the sector is vital if new and better ways of performing its key teaching, research and community service roles are to be discovered.

Competitive pressures on state institutions to perform can be expected to increase due to the demands of a fast-growing, outward-looking economy and a more diverse society. An increasingly competitive environment in the sector has several implications. First, the government is likely to seek improved accountability arrangements to safeguard its substantial stake in state institutions. Secondly, a more competitive environment increases the need to provide sufficient flexibility to state institutions to enable them to respond to changing requirements. Greater flexibility in the longer term could be achieved by according greater autonomy to state institutions. In the shorter term it could be achieved by changes to governance arrangements and reduced input controls.

Before moves towards greater autonomy could be contemplated, however, tuition and research funding and regulatory policies would need to be changed to treat state and other providers in a more even-handed manner. These changes would increase the incentives for state institutions to respond to the needs of their student clients and to public good research priorities.

SUBMISSIONS

SUBMISSION ON THE DRAFT ANNUAL PLAN OF THE CHRISTCHURCH CITY COUNCIL

NEW ZEALAND BUSINESS ROUNDTABLE
MAY 1995

CHRISTCHURCH CITY COUNCIL'S
DRAFT 1995/96 ANNUAL PLAN

Executive Summary

- Christchurch's urban services are generally considered to be of a good standard and the city's finances have been maintained in recent years in a sound overall condition. This reflects credit on the planning and management of those - mayors, councillors, and employees - who have been entrusted with those responsibilities.

- Looking to the future, the necessary strategies for the Council are:

  - to identify its core functions and priorities according to proper 'public goods' criteria, and perform them at a high standard;
  - to fund services according to accepted principles of local government finance, i.e. user charges where practicable, and efficient and equitable rates where not. Dividends from commercial activities are not an appropriate source of finance for non-commercial activities; and
  - to minimise the costs and risks for those who use and those who pay for services.

- However, the Plan proposes major departures from these strategies:

  - continuing heavy involvement in commercial activities through Christchurch City Holdings Limited (CCHL), as well as commercial property development, off-street parking facilities, rental housing and promotions - all private goods;
  - the resulting revenue requirement is excessive and too much of it is planned to be met from unsustainable and probably unlawful levels of rates on commercial and industrial properties; and
  - a dangerously excessive exposure to financial risk is planned, through increasing reliance on costly borrowed capital and on uncertain future profits from commercial activities. Such a gamble on future interest rates and dividends would sooner or later backfire on the Council and its stakeholders, yet it is planned to continue into the next century.

- The Council should plan to:

  - maintain the high standards of provision of core public good services and corporatise appropriate services;
  - divest its holdings in non-core activities such as CCHL/Southpower, Selwyn Plantation Board Ltd, Christchurch Airport, Lyttelton Port, Christchurch Transport, commercial property, off-street parking, and most or all rental housing;
  - expand the application of user charges for core services and reform its rating system to bring it into conformity both with the law and with recognised criteria of efficiency and equity; and
  - apply the proceeds of divestment first to debt reduction and then to funding of non-realisable assets required for core activities.

1.0 Core functions and priorities

1.1 The core function of local authorities is to ensure that local public goods are provided in the right amounts, times and places, and to the right standards - having regard to costs as well as benefits. Public goods or services are those which individuals cannot be excluded from enjoying even if they don't pay for them, or ones whose use by some individuals does not reduce the availability of the goods or services to others. Street lighting is a common example. Most so-called public goods are actually a mixture of public and private goods (e.g. libraries and museums) and identifying them is a matter of judgment as well as facts.

1.2 There is plenty that the Council is doing, and should keep doing, to make Christchurch a good place in which to live, work, and do business. These things are its proper priorities. It could do them even better if it focuses sharply on them and avoids the distractions and risks associated with non-core and hence non-strategic activities. It should, however, analyse the organisational options for core services - e.g. corporatisation - to gain the best results at least cost. In line with the same objective - best results at least cost - every activity should be exposed to competition to the greatest extent possible.

1.3 Housing is largely a private good. To the extent that there is a case for government involvement on equity grounds it is recognised as a responsibility of central government. Hence the government owns Housing New Zealand and government housing subsidies (accommodation supplements) are centrally funded and administered. With the possible exception of some temporary emergency rental housing, we believe the Council has no business being in the rental housing industry. Its current involvement - it owns some 2,500 rental units - goes far beyond emergency housing. Under the plan, ratepayers are to subsidise tenants by more than $6 million in 1995/96 - an average of over $2,400, or $46 per week, for each unit. As well as being costly, this is a waste of ratepayers' money because many tenants would receive assistance (or more assistance) from the government if they were paying market rents.

1.4 The Council's involvement in more purely commercial activities (CCHL and other businesses) is also unjustified. They produce private, not public goods. The risks associated with the Council owning them are discussed below.

1.5 The Council proposes to continue with a range of economic development and employment activities. We do not believe that the Council should be involved in most of these. Assistance to particular firms or industries means that higher taxes (in the form of a higher level of rates than otherwise) are imposed on others. This simply benefits the favoured recipients at the expense of the rest of the community. It does nothing to increase business development overall in the region, and indeed sets it back because the higher rates will, at the margin, drive some businesses and residents elsewhere. The most constructive contribution that the Council can make to the local economy is to restrict its activities to those that should validly be performed by local government and perform them efficiently, and thereby reduce its expenditure and rates.

1.6 A similar argument applies to employment schemes. Unemployment has been falling sharply in New Zealand since the labour market reforms were implemented in 1991 and the government regained control over its own spending. The best contribution central and local governments can make to employment growth is to rein in their own activities and make room for private sector expansion. As many studies have documented, so-called public sector 'job creation' schemes (whether run by central or local governments) are nothing of the sort. While some specific jobs are created due to subsidies or the provision of work, others are destroyed in the process because unsubsidised workers are displaced from other firms and the additional taxes or rates needed to finance them mean a reduction in private sector spending power and hence less employment in the provision of other goods and services. With the rapid rates of employment growth now being experienced, such schemes should be phased out as rapidly as possible.

2.0 Revenue

2.1 It is extremely disappointing that the review of revenue policy which, according to last year's Plan was to have been completed early in 1994/95, has been delayed. This review was to have provided the framework for the Council to determine appropriate revenue sources for all its activities and to have an impact on the structure of rates and revenue commencing in 1995/96. The review should be completed with all deliberate speed. In the meantime, the proposals below - which are consistent with any likely outcome of a properly conducted review - should be adopted.

2.2 The obvious and appropriate sources of revenue for core services are user charges and rates. Of the two, user charges are to be preferred wherever they are practicable because:

- user charges signal to users the true resource cost of provision and encourage economy in the use of resources;
- user charges generate revenue to fund services in proportion to the true demand for them; and
- user charges encourage the use of lesser-cost alternatives where available.

Rates do none of these things.

2.3 It would be inappropriate and impracticable to recover through user charges all or even a significant part of the costs of such things as public accountability and parks. However, other activities can and should be funded entirely or substantially by user charges. Examples include the following (costs are as shown in the Plan for 1995/96):

Activity	Gross cost ($m)	Net cost ($m)
Water services	50.8	47.2
Sewerage	36.2	34.2
Library services	15.9	14.8
Art gallery	2.1	1.7
Leisure & community services	15.5	11.8
Economic development & employment	15.1	5.5
Housing (see also above)	13.8	6.1
Christchurch Town Hall	6.1	3.9
Totals	155.5	125.2

The average cost recovery of these services is only 20 percent. If that were raised to an average of 60 percent, the call on rates to fund these activities would reduce by $62 million i.e. by half. This amount is well over half the $106 million total for rates to be collected in 1995/96. Such a reduction is entirely feasible. For example, with the metering of water supply, the cost of supplying water and disposing of waste water can be entirely recovered by a single volume charge covering both, which alone would reduce the demand on rates by over $80 million. Further reductions would follow from applying user charges to other services and discontinuing funding of services (such as economic development and promotions as discussed in section 1.5) which are largely private, not public goods.

3.0 Differential rating

3.1 Commercial and industrial ratepayers are levied a differential on the General rate loading of 130 percent over residential properties and pay 44 percent more rates than they would if there were no differential rating or annual general charge. The Plan does not say how much this amounts to in dollars. However, from the scanty information given it is surmised that it will be some $10-15 million in 1995/96.

3.2 According to the Plan:

"The purpose of the differential on Commercial/Industrial properties is to

- counteract the reduction in rates from this sector which would otherwise result from the Uniform Annual Charge
- recover from the business sector a greater share of costs relating to:
  - economic development and promotion
  - city amenities which enhance tourism and retailing
  - more intensive roading and traffic requirements
  - extra capacity requirements for drainage and water supply
- partially recognise the benefit of tax deductibility available to business."

3.3 These arguments do not stand up to scrutiny:

- the Uniform Annual Charge should be superseded by user charges, not used to justify distorting the rating system;
- economic development and promotion should be the business of the business sector itself, using its own money; the Council has no justification for involving itself and taxing the sector to fund it;
- city amenities which enhance tourism and retailing will pay for themselves by increasing the capital values, and thereby the ordinary rate payments, of the properties that benefit from the enhancement;
- roading and traffic requirements correlate more closely with intensity of site use - which is reflected in capital value - than with categories like commercial/industrial or residential; and
- extra capacity requirements for drainage and water supply should be recovered directly, by user charges, as pointed out earlier.

3.4 In addition, the claimed benefit of tax deductibility available to business is a fallacy. Income earned by firms is generally subject to income tax. Because firms are taxed on a net rather than a gross basis, a deduction for expenditure on rates is permitted. Residents receive a deduction for rates if their gross income is taxed, for example where property is rented. However, where gross income, for instance the implicit rents that accrue in respect of owner-occupied housing, is not taxed, a deduction for related costs including rates is disallowed. Owner occupiers are, if anything, relatively advantaged because they do not pay tax on the net income that arises from their investment in housing. It follows that firms do not gain an advantage over residents because they can deduct rates for tax purposes.

3.5 A related claim is that businesses are favoured because they can claim an input tax credit for GST paid in respect of rates. However, GST was designed to impose tax on final consumption spending. For this reason, firms (but not final consumers) generally receive a deduction for GST paid on inputs. This deduction is intended to avoid a cascade effect where the amount of tax is affected by the number of traders involved in the production and distribution of goods and services. Business firms, other than those supplying exempt services, pay GST on the net value that they add. The sum of net value added by each firm, together with the cost of imports (which are subject to GST at the border), equals the final selling price of goods and services. There is no concession for firms.

3.6 This fallacy concerning the preferred tax status of business should therefore be disposed of once and for all.

3.7 The most recent High Court decision on differential rates is that of Mr Justice Ellis in Woolworths NZ Ltd and others v. Wellington City Council. In his judgment issued on 15 May 1995 the judge held that "... the dominant consideration for determining a reasonable differential in a rating system must be the value of services rendered to the ratepayer by the Council." It is clear that Christchurch's differential loading is not justified by the value of services rendered to commercial and industrial ratepayers. Consequently it is probably unlawful, and the Council should reconsider it forthwith. The proper extension of user charges and the other proposals in this submission would permit the differential loading to be phased out altogether without any corresponding increase - and in fact a significant reduction - in residential rates.

4.0 Risks associated with investments

4.1 The Financial Overview in the Plan projects through to 2000/01 the consolidated results of the Council's financial policies and assumptions. According to these:

- rate revenue will rise from $105 million to $133 million per annum, or 27 percent;
- net debt will rise from $160 million to $249 million or 56 percent;
- the ratio of term debt to realisable assets will rise from 2 percent to 31 percent;
- $71 million will be spent on enhancement projects (little or none of which will be realisable);
- dividend income will rise from $4.32 million to $6.03 million per annum, or 40 percent;
- net interest costs will rise from $1.1 million to $7.14 million per annum, or 650 percent. This assumes that interest rates will be 9.5 percent in 1995 and 7.5 percent in all subsequent years.

4.2 However, only single assumptions and projections are offered in this analysis rather than a range to test for sensitivity to alternative outcomes. Consider the position taking one year only - 2000/01 - and altering modestly two of the Council's assumptions, namely that, because of a downturn in the economy:

- CCHL (representing the Council's commercial equity investments) pays no dividends that year, instead of the $6.03 million assumed; and
- interest rates are 10 percent instead of the 7.5 percent assumed.

All else being equal, an additional $6.03 million would need to be found to cover the missing dividend income, and $6.23 million to cover the additional interest expense. This would mean a total of $12.26 million would be added to rates, raising the rate requirement by 9 percent to over $151 million, or 44 percent more than in 1995/96.

4.3 Even worse outcomes are entirely possible in 2000/01, or indeed in any year or years between now and then. Falling CCHL profits and rising interest rates would impact on the value of realisable assets, so that instead of these increasing over the period from $833 million as projected they could fall substantially and be worth less than they are now. The Enerco experience is an illustration of how quickly and badly a commercial investment can deteriorate.

4.4 The riskiness of the Plan is apparent. People and businesses struggling in an economic downturn will be hit by substantial rate increases when they can least be afforded. This is unnecessary and unacceptable. The Plan should be revised to prevent it happening.

4.5 Instead of gambling on uninterrupted economic prosperity, the Council should:

- sell all its commercial assets, with appropriate safeguards in the case of housing to protect the legitimate interests of tenants;
- repay debt; and
- fund justifiable enhancement projects as they can be afforded from ordinary income.

4.6 The interests that should be divested include:

- Christchurch City Holdings Ltd and its subsidiary Southpower Ltd. There is no reason for a territorial authority to own shares in an electricity retailer and some territorial authorities have privatised their interests or are planning to do so. There is even less reason or justification for the Council to own an interest in a company retailing outside Christchurch as Southpower does.
- A 75 percent stake in Christchurch International Airport Ltd. Most local authorities do not run airports and there is no reason or justification for Christchurch City to do so. In Australia and New Zealand, airports are being privatised.
- A 65 percent stake in Lyttleton Port Co. Ltd. Again, most local authorities do not own ports and there is neither reason nor justification for Christchurch City to be involved in the ports industry.
- A 77.8 percent share of Port Finance Ltd. Instead of this stake being transferred to CCHL it should be sold.
- Christchurch Transport Ltd, which is wholly owned by the Council. Most local authorities do not own public passenger transport operations and neither should the Council, which should follow the successful example of Wellington and privatise the business. In Wellington the privatised company Stagecoach has held fares in dollar terms since 1990 and reduced them by 10 percent in real terms, increased passenger numbers significantly and reduced subsidy requirements from $14 million to $5 million p.a., saving Wellington ratepayers $9 million a year.
- A 39 percent share in Selwyn Plantation Board Ltd. There is no justification for the Council to be involved in a commercial forestry venture.
- Streetworks Management (Christchurch) Ltd, which is wholly owned by the Council. It employs no staff directly but sub-contracts out its total workload. The Council should sell the company or wind it up.
- A one-third share in Canterbury Technology Parks Joint Venture. It is pleasing to note that the Council is concluding its involvement in this venture.

4.7 There is now clear-cut evidence - summarised, for example, in World Bank reports and many academic studies - that privatisation of businesses owned by governments at all levels brings significant economic benefits. On average, businesses subject to commercial market disciplines perform more efficiently than businesses subject to political control. Consumers, employees and taxpayers all tend to benefit. New Zealand experience with privatisation has been consistent with these findings. Privatisation programmes internationally are extending in various ways into areas like water supply and roading, and economic development will be handicapped in New Zealand if similar initiatives are not pursued.

4.8 In financial terms the benefits of a programme of divestment which included the investments listed in section 4.6 and other potentially saleable assets of the Council may be summarised as:

- elimination of the commercial risk associated with the assets;
- elimination of dependence on revenue flows from the assets to service debt;
- elimination of Council debt corresponding to the sale value of the assets;
- elimination of the interest payments and interest rate risk associated with the debt; and
- elimination of the unnecessary and undesirable distraction from the Council's core activities which commercial activities represent.

4.9 The hope that, over time, the Council can profit from these activities is an illusion. The Council does not and cannot have a comparative advantage over the private sector either in running commercially successful businesses or in choosing directors to do so. Even if in any year or years the businesses are profitable, experience suggests that over time they are unlikely to justify the debt-related and other costs and risks that are associated with them. There are numerous examples in New Zealand to show that any of them is liable to fail disastrously. Ratepayers should not be involuntarily exposed to these costs and risks.

4.10 The Council's involvement in business ventures is as unnecessary as it is undesirable. It reached its present generally sound financial position without relying on dividends or capital from Council-owned businesses. Rates and user charges, together with prudent borrowing for capital projects, are the appropriate sources of funding for core local government activities. The loss of an income stream from the sale of commercial assets would be accompanied by a retirement of debt and a reduction in debt servicing costs. The Council's net financial position would be improved as a result of asset sales because the expected superior performance of the assets under private sector management would be capitalised into a sale price which would exceed the net present value of the projected earnings streams under Council ownership. Accordingly there is no reason why the Council could not maintain its core activities after disposing of its business ventures.

SUBMISSION TO FEDERATED FARMERS OF NEW ZEALAND (INC) ON REGULATORY ARRANGEMENTS FOR THE MEAT AND WOOL SECTORS

NEW ZEALAND BUSINESS ROUNDTABLE
APRIL 1995

Regulatory Arrangements for the Meat and Wool Sectors

Introduction

The minister of agriculture in a letter of 17 March to agricultural sector leaders outlined his preliminary views on the nature of the regulatory regime that should apply to the meat and wool sectors. Federated Farmers of New Zealand ('the Federation') has also been considering these issues. The Federation released a draft policy paper in early March and invited submissions from its members by 19 April. Our comments on an appropriate regulatory framework for the meat and wool sectors apply both to the issues raised in the minister's letter and the draft policy of the Federation, since they both traverse similar territory.

In general, the New Zealand Business Roundtable endorses the direction of thinking in the minister's letter and the Federation's draft policy statement. In particular, we agree that the Meat and Wool Boards should not be involved in commercial activities and that the boards should divest themselves of their existing investments forthwith. We do not agree with arguments the boards have advanced in the past that disposal of their commercial investments should be deferred until a better sale price can be obtained. Uncertainty about future ownership may hamper the commercial activities of board subsidiaries and may erode their value. Immediate disposal would settle the ownership issue and remove uncertainty for the companies affected.

The direct allocation of shares in board subsidiaries (or in a holding company) seems to be a viable option which has yet to be adequately explored. Under such an option, farmers would be in a position to choose for themselves the most opportune time to dispose of their interests, if at all. The allocation of power company shares to their customers might be a useful model to follow.

The basis of an appropriate regulatory regime

New statutory arrangements for the meat and wool sectors envisaged in the minister's letter would be regarded as normal among participants in the highly successful forestry, tourism, fishing and manufacturing sectors. Proposals raised by the minister included:

- the development of a product classification system by the industry, tailored to the needs of the market;
- reviewing the appropriateness of a producer-dominated body to exercise control over other commercial entities;
- repealing the control powers of the Meat Board over the disposition of specific meat products or all meat (powers which have not been exercised in recent years);
- the separation of issues relating to the allocation and enforcement of quota allocations to restricted markets from those relating to marketing;
- removing the powers of the Meat Board to impose shipping services and set maximum shipping rates; and
- removing the powers of the Meat Board to give direction on a wide range of matters, including the handling, pooling, storage, shipping, distributing and disposing of New Zealand meat, as well as insurance against any losses.

These proposals are also broadly consistent with the direction of reform evident in the Federation's draft policy statement. In a letter to farming leaders, the chairman of the Meat Board labelled the suggested moves as "radical". The wide arsenal of interventions available to the boards would be regarded as intolerable to investors in any other sector, or most other countries. Accordingly, we are surprised and disappointed at the attitude of the Meat Board reflected in the chairman's letter.

Too many of the contributions to the debate seem to reflect self-serving 'turf protection' and a presumption that a high level of intervention is the norm. The onus seems to be placed on those suggesting a reduction of statutory powers or a relaxation of the monopoly provision of certain marketing and research services provided by the boards to justify that stance. For example, in a letter to provincial presidents of Federated Farmers, the chief executive of the Wool Board concluded that "we are not prepared to recommend to farmers that the funding arrangements for their wool research, product development and promotional programmes be put at risk until such time as we see hard-nosed commercial evidence that the 'institutional arrangements' which currently are exercised in the wool industry should be replaced." Similar sentiments have been expressed by the Meat Board in the form of claims that its powers are necessary to maintain prices, prevent "commodity selling" (which, it is implied, is undesirable although reasons are not given) and prevent quality falling to the "lowest common denominator".[1]

In contrast to the minister's letter and the Federation's draft policy statement, the public stances of the boards have tended to diminish, rather than contribute to, an informed understanding of how complex markets actually work in the beneficial interests of buyers and sellers. For example, markets, not producer boards, determine the prices for our products. Our overseas competitors are free to 'weak sell' (i.e. compete and take market share) if New Zealand exporters are impeded from doing so.

The boards also appear reluctant to accept that markets can overcome commonly cited 'free rider' problems in relation to promotion and research through the development of property rights such as brands and patents.[2] The funding of generic promotion and research by the boards is likely to have displaced privately-funded expenditure and retarded the development of strong and enduring linkages between exporters and foreign buyers.

With the support of appropriate legislation to protect property rights, markets are able to deal with problems commonly cited as needing unorthodox arrangements for the meat and wool sectors. Other sectors in New Zealand have prospered through the free interplay of buyers and sellers. Nothing the boards have said provides a valid reason why the same should not also be true for the meat and wool sectors. The onus should be on those who argue for special rules for the meat and wool sectors to establish a positive case for any interventions based on sound analysis - not the converse. Apart from the need to cater for mandatory requirements imposed by other

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1 *New Zealand Herald*, 7 April, p. 12.

2 In a letter to Federated Farmers leaders, Mr Grant Sinclair of the Wool Board sought examples of "effective mechanisms" which can be put in place to exclude non-payers from enjoying the benefits of R & D and promotional expenditure. Such examples abound in the market such as branding of products and protection of research investments through patents, although they are probably more developed in other sectors. The role of these property rights is discussed on p. 21 of the September 1994 Discussion Paper released by Federated Farmers. The implications of the development of stronger patent, licensing and copyright arrangements which have made it easier for companies to capture and protect the benefits of research have also been noted by the Industry Commission in Australia. The Commission concluded that stronger property rights were a contributing factor to a new climate that provided greater opportunities for research by individual companies (Industry Commission (1994), *Meat Processing*, Report No. 38, Melbourne, Australian Government Publishing Service).

countries and the need to ration access to quota-restricted markets, a valid case for interventions specific to the meat and wool sectors has yet to be established.

The likely retort of those who defend the current extensive statutory powers is that wool and meat are somehow 'special'. However, all goods and services sold in a market are 'special' in that they have characteristics that distinguish them from each other - hamburgers are different from pizzas, fish is different from forestry, wool is different from cotton. The misconception that 'specialness' applies only to meat and wool has blighted the development of a strong and diverse agricultural sector in New Zealand.

The adverse effects of inappropriate intervention

Regulatory controls are likely to have set back the development of our meat and wool markets. Many of the dimensions upon which New Zealand exporters of meat can compete have often been controlled, such as mandatory grading and regulated shipping. The more extensive the controls over product type and delivery, the greater the incentives for New Zealand sellers to compete solely on the basis of price. The range of interventions and the funding of generic promotion may also have artificially reduced barriers to entry of new players, as noted in the Federation's draft policy statement.

Of course, substantial investment in grading, processing and branding may not yield a worthwhile return for some products. In any market, people make returns by supplying a range of product and qualities. The tourism sector is an example, where target markets range from tourists interested in low-cost 'backpacker' packages to those interested in luxury service. In all cases, the success of the sellers is determined by whether the expectations of purchasers are met or exceeded and whether the activity is profitable.

It is no more valid to assume that New Zealand exporters should sell, and overseas buyers be offered, meat and wool of uniform quality and specifications than it is to assume that in-bound tourists should be offered only one type of holiday package. A strong and diverse agricultural sector would provide a range of products, of differing quality and price, depending on the needs of customers. So-called 'commodity selling', a term of detraction when used by the Meat Board, would appropriately stand alongside the marketing of meat or wool in more processed forms.

The existing range of controls in the meat and wool sectors promotes a culture which rewards conformity and retards risk-taking and diversity. It is unlikely that regulators have sufficient information, or appropriate incentives, to act adroitly to respond to continuous changes in complex world markets for meat and wool. Regulators are more likely to get in the way. The existence of controls promotes uncertainty for potential investors. The risk premium they will demand will increase the cost of capital. This is contrary to the interests of growers and other stakeholders.

Controls can also retard enterprise and innovation by obscuring responsibility. Wool and meat processors and exporters, politicians, farmers and unions can each believe that, somehow, market interventions will offset their own failings or that such controls can remedy a downturn in the market that is beyond anyone's control.[3] This contributes to the politicised nature of the meat and wool sectors. Experience to date suggests that the attention of industry participants will continually be diverted by the

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3 Conversely, defenders of controls might seek to point to the existence of such controls as being a significant contributing factor to an improvement in the market which is, again, caused entirely by exogenous factors.

political imperative to monitor, or lobby to change, controls that have the potential to protect the position of one stakeholder against another. Time spent on lobbying is time not spent on industry and market development.

Despite strong grounds for repealing most statutory interventions, there seems to be a reluctance by the boards, and the Meat Board in particular, to give up their powers, even though some have not been exercised for several years. There seems to be a concern to retain powers in order to provide some unspecified 'safeguard' against future shocks, or because once such powers are given up they may not be conferred again.

These reasons for retaining the current statutory powers are specious. Existing controls reduce, rather than enhance, the ability of the meat and wool sectors to withstand future market shocks. They reduce the latitude open to enterprising and innovative participants in the industry to seek out new market opportunities. They increase the costs of capital, particularly in the meat industry. They reduce diversity and responsiveness in the provision of marketing services. Controls that apply to the meat and wool sectors reflect an era when New Zealand's regulatory environment stifled growth and made our exporters far more vulnerable to adverse changes in our markets. As a result of greater flexibility in factor and product markets stemming from the removal of unjustified regulations, other sectors of the economy are far better prepared to meet new challenges. Reforms in the meat and wool sectors are likely to produce a similar result.

The significant financial risk to growers from the use by the boards of their powers should not be ignored. Losses by the boards have cost growers dearly in the past. It seems as if lessons from the past have not been learned. Staff and members of the Meat Board, for example, still sometimes assert that powers of acquisition are required in certain circumstances, such as when meat is offered for sale by a 'weak seller' (e.g. the receivers of a company). The relevant question is whether the Board's intervention in these circumstances (using growers' money) will be any more successful than any other company (using its own money) seizing upon a market opportunity to acquire low-cost product. We doubt whether that will generally be the case. The result may simply be financially troubled companies offloading their costs on to growers.

If growers believe they are able to exploit arbitrage opportunities because of poorly informed sellers, they have the opportunity to achieve this through companies they own or choose to set up. No specific powers for the boards are necessary.

Future directions

The real value of the services provided by the boards would be crystallised by exposing the boards to greater competition. This would include charging for the use of board-developed brands. If those brands are valuable to exporters or overseas buyers, they would be prepared to pay for their use. If the boards consider that minimum prices and mandatory classifications are necessary for effective marketing, such restrictions can be linked to the use of board-developed brands. Exporters or foreign buyers who recognise the value of such an approach would be prepared to abide by the restrictions in order to reap the rewards. Others would be free to pursue alternative marketing strategies.

Many participants in the meat and wool sectors, including many farmers, fear less regulation. They may consider that they will be the 'losers' from greater competition. The arguments for deregulation may be viewed as 'theoretical' with little practical evidence of benefits. As noted above, some of these fears seem to be exploited by the boards to protect their current, protected roles.

In contrast to this populist mythology, there is growing international evidence that the benefits of deregulation are tangible and that all stakeholders benefit. A recent detailed study of the benefits from regulatory reform affecting airlines, railroads, trucking, telecommunications, television, banking, security brokerage, petroleum and natural gas concluded that the United States gained amounts equal to a 7-9 percent improvement in the contribution of the affected industries to gross domestic product. Some net benefits could not be quantified. Contrary to some expectations, employees and producers both benefited from deregulation. The facilitation of competition was a central feature of the reforms that were examined.[4]

Markets will not always get things right, particularly if outcomes are compared to the theoretical ideal of perfect competition which is characterised by price-taking behaviour and perfect markets, instantaneous clearing prices and costless transactions. There is no doubt that critics will continue to be able to point to incidents where exporters might undersell a market. However, these 'failures' do not represent a valid reason for regulation. The relevant policy question is, instead, whether regulatory interventions are superior given that they also result in less than ideal outcomes. One commentator has observed that:

> ... markets left to themselves may turn in a pretty poor performance, but not nearly so poor when left alone as when tinkered with, especially when the tinkering is simplistically done or done cleverly to disguise the size and distribution of the costs or losses associated with some "innocuous" favoritism.[5]

In a similar vein, Nobel laureate Ronald Coase has observed that:

> The ubiquitous nature of "externalities" suggests to me that there is a prima facie case against intervention, and the studies on the effects of regulation that have been made in recent years in the United States, ranging from agriculture to zoning, which indicate that regulation has commonly made matters worse, lend support to this view.[6]

The conclusions of these commentators, and the weight of international evidence, lends support to the judgment that less regulation of the meat and wool sectors would enhance the contribution of these sectors to the New Zealand economy and further the interests of all stakeholders, including growers.

Conclusions

The New Zealand Business Roundtable agrees that the powers of the boards should be reduced, along the lines envisaged in the minister's letter and the Federation's draft policy. We also agree that the boards should be exposed to greater accountability through regular renewal of their mandate through referenda. The direct election of board directors and annual general meetings, as currently proposed, are no substitute for wider accountability. In the case of listed companies, accountability is provided through the operation of the share market through which shareholders can signal directly their rating of a company's performance. This avenue is unavailable in the case of the Meat and Wool Boards. Referenda would only fill this gap in a minor way.

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4 Winston, Clifford (1993), "Economic Deregulation: Days of Reckoning for Microeconomists", *Journal of Economic Literature*, XXXI (September), pp. 1263-1289.

5 Schelling, Thomas C. (1981), "Economic Reasoning and the Ethics of Policy", *The Public Interest*, 63, pp. 37-61.

6 Coase, R.H. (1988), *The Firm, the Market and the Law*, Chicago, the University of Chicago Press.

A competent organisation, confident in its role, should not fear periodic assessment and renewal of its mandate.

However, we question the need to retain the boards at all. Their historical performance and their public (and often partisan) stance on reform proposals indicates that they are slow to adapt to change or to recognise the responsibilities that go hand-in-hand with extensive statutory powers.

It is doubtful, in our view, that the boards would embrace desirable changes to the regulatory environment or make the most of them. We therefore suggest that the government and the Federation should consider repealing all legislation specific to the meat and wool sectors other than that necessary to provide mandatory accreditation (where required by our export markets) or to ration access to quota-restricted markets. Neither of these activities needs to involve a producer organisation such as the Meat and Wool boards.

If growers wish to fund research and promotion, they can do so through commercial means. Alternatively, the provisions of the Commodity Levies Act are available if a sufficient number of growers wish to institute a levy to fund promotion and research.

SUBMISSION TO THE TRANSPORT COMMITTEE OF THE HOUSE OF REPRESENTATIVES

ON THE

LAND TRANSPORT LAW REFORM BILL

NEW ZEALAND BUSINESS ROUNDTABLE
APRIL 1995

Summary

1. This submission on the Land Transport Law Reform Bill (the Bill) is made by the New Zealand Business Roundtable (NZBR). It follows the NZBR's September 1994 submission to the Ministry of Transport on its July 1994 discussion paper *Land Transport Strategies and Network Funding.*

2. The NZBR strongly supports moves to separate provision of road infrastructure from funding, policy advisory and regulatory functions.

3. The creation of an independent New Zealand Roads Board (the Board) within Transit New Zealand (TNZ) is a useful step in this direction. It will separate procurement of national road infrastructure facilities from the provision of state highway infrastructure.

4. In the NZBR's view the proposed primary objective statements for both the Board and TNZ should be improved by making efficiency of allocation and provision the sole objectives. This change would improve the focus and accountability of both organisations without compromising safety. If desired, safety could be specifically mentioned - as an efficiency consideration.

5. The powers and functions of the Board, in conjunction with the independence conferred on it, appear to be appropriate and to have the potential to give a strong efficiency orientation to its activities.

6. The concept of a dedicated fund reflects an understandable desire to reduce provider vulnerability to *ad hoc* political decision making about expenditures from the Land Transport Fund. However, to the degree that it is based on the belief that revenues for road users should always be earmarked for spending on roads, the results are likely to be disappointing. Governments are accountable to the electorate for allocating funds to the highest return activities, regardless of their sector of origin. Funds for roading should not be insulated from this broad cost-benefit calculus. There will be times when the road infrastructure is rightly a net generator of cash for the public sector and times when it is a net user of cash.

7. The proposed Land Transport Strategies raise all the difficulties associated with centralised indicative planning. While there are genuine difficulties which must be addressed in respect of priorities for state procurement of *road* infrastructure facilities, it is far from obvious why *land* transport should be singled out for such strategic planning. Sea and air transport do not get the same attention and there are no grounds for treating privatised rail and bus transport differently in this respect.

8. The NZBR recommends that the issue of a national land transport strategy in Part II of the Bill should be revisited with a view to restricting its focus to road transport or, preferably, to road infrastructure procurement.

9. An inevitably politicised process for determining a national strategy for the road network could result in specific objectives which are inconsistent with the efficiency and safety objectives set for the Board and TNZ. To require, as is proposed, the Board and TNZ to use an efficiency objective to produce road expenditure programmes which are "not inconsistent" with the national strategy could be to ask them to reconcile the irreconcilable.

10. Rather, the process to be put in place should require the Board and TNZ to identify, using their project analysis techniques, the magnitude of the funding subsidies (or taxes) which would be necessary in order to induce providers of infrastructure to supply those outputs required by the national objective which are inconsistent with the efficiency objective. The government would then have to review its national goals

and/or determine how to fund the required subsidy (or impose the tax). The government would not necessarily wish to fund the subsidy from (or impose the tax on) road users who do not use the relevant portions of the network. For example, should the government wish to spend more on rural roads than can be justified under the Board's efficiency-oriented project appraisal processes, it should pay an explicit subsidy to the Board for that procurement purpose. The Board would determine its procurement policies on a subsidy-inclusive net benefit basis. Policy would be transparent, national objectives would be properly funded, and the integrity of the Board's efficiency objective would be maintained. Nor would non-rural road users necessarily be expected to bear the burden of such a subsidy.

11. Implementing this suggestion would require amending the proposed sections 42B and 42E so that they require transparency of treatment of inconsistencies and a process for addressing them - rather than the absence of inconsistencies.

12. The NZBR strongly recommends that the Bill reinstates the provisions of the 1989 TNZ Act in respect of competitive pricing procedures for in-house professional services. The original (1991) reasons for removing these provisions are even less compelling with the passage of time and the implementation of the Employment Contracts Act than they were in 1991. There appears to be no sound public policy reason for insulating the supply of local authority professional road services alone from competitive provision.

13. For competitive neutrality, it is important that local authority services enjoy no inherent tax advantages compared with private sector competitors. This is likely to require units which wish to compete with private sector providers to form LATEs.

14. The NZBR favours retention of the 30 June 1995 expiry date for regional petrol taxes. While there is a potential role for wider application of user pays principles in respect of regional roads, a petrol tax may not be superior to other charging systems and regional authorities do not face strong incentives to tax efficiently.

15. The proposed Bill provides an opportunity, which has not been taken up, to correct a substantial and fundamental inconsistency in the Local Government Act 1974 affecting Auckland's Yellow Bus Company. The effect is to impose very different divestiture requirements on bus services in Auckland from those applying elsewhere. There are no sound public policy reasons for allowing this unintended situation to continue. One solution would be to include in the Bill a clause which would amend the Local Government Act 1994 to provide that the requirements in Part XXXIVB could not be overridden by anything in (the appropriate sections of) Part XLIVB of the Act.

1.0 Introduction and Overview

1.1 This submission on the Land Transport Law Reform Bill (the Bill) is made by the New Zealand Business Roundtable (NZBR). The NZBR is an organisation of chief executives of major New Zealand business firms. Its purpose is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 The road network is a critical part of New Zealand's infrastructure. The NZBR assessed alternative arrangements for the organisation of roading in its June 1993 study *Options for the Reform of Roading in New Zealand.* This paper identified a large number of concerns with current arrangements. It also considered alternative arrangements which would bring a greater commercial focus to the provision of road network services. Key concerns included conflicting objectives, institutional overlaps and mixed incentives, and inadequate information about user preferences in relation to costs.

1.3 The Bill follows the publication in July 1994 of the Ministry of Transport's discussion paper *Land Transport Strategies and Network Funding*. The proposals in that paper were aimed at allowing clearer nationwide objectives to be set for the provision of land transport; facilitating more decentralised decision making in respect of expenditure priorities; and establishing traffic-volume based funding.

1.4 The NZBR made a submission to the Ministry of Transport on its discussion paper in September 1994. It noted that the quality of the outcomes likely from the proposed changes would be very dependent on the incentives embodied in the contractual arrangements between the Crown, as the funding agency, and the providing agency or agencies. It expressed doubts that the proposed national goals and strategy approach would significantly improve on the current situation because of the problems of conflicting objectives, limited information and poor accountability. The submission favoured less emphasis on setting detailed national goals and more on improving institutional arrangements and incentives. On funding, it noted the critical need for funds to be transferred from regions or activities in which marginal returns were low to high-return regions or activities. There was a danger that this would not occur adequately and that there would be too little emphasis on rigorous cost-benefit assessments of competing projects. These concerns remain.

1.5 Turning to the current Bill, the NZBR supports its basic underlying philosophy, namely that provision should be separated from funding and that the role for contracting-out should be increased. Provision should be increasingly put on a fully commercial basis. The current lack of an economic direct billing system significantly constrains pricing structures and limits what can be done to improve provider incentives. However, new billing technologies promise to ease this constraint within the economic life of the existing road system. In the meantime, policy should be anticipating this development and moving towards a regulatory environment which will be conducive to growing private sector involvement in, and competition for, the supply of road services.

1.6 Section 2 below relates to Part I of the Bill. It looks at the proposed objectives, functions and powers for the New Zealand Roads Board (the Board) and the proposed annual performance agreement. It suggests changes to the Board's composition and objective statement. An associated change to Transit New Zealand's (TNZ's) objective statement is also suggested.

1.7 Section 3 looks at the features in the same part of the Bill which aim to create a dedicated fund for road expenditures. It identifies an important limitation to the concept of a dedicated fund and explains why it is undesirable to provide that revenues received from road users should always be earmarked for roading.

1.8 Section 4 considers the land transport strategy sections contained in Part II of the Bill. It raises concerns about the scope of the planned strategies and their potential to create irreconcilable conflicts for the Board and TNZ. A narrower, more transparent, approach is suggested.

1.9 Section 5 considers three issues applying specifically to the local government sector: the competitive provision of professional roading services in local government; regional petrol taxes; and a policy inconsistency affecting Auckland's Yellow Bus Company. The first of these issues relates to section 30 of Part I of the Bill while the others relate to the Local Government Act 1974 and Part V of the Bill.

1.10 This submission does not comment on matters covered in parts III, IV, VI and VII of the Bill. These parts primarily clarify administrative aspects of existing policies.

2.0 The New Zealand Roads Board

2.1 Clause 9 of Part I of the Bill creates the Board. It will be a subsidiary of TNZ and will assume TNZ's procurement responsibilities.

The Composition of the Board

2.2 The Board will consist of 5 members. They will be appointed by the Governor-General on the recommendation of the Minister of Transport. Three will be from TNZ, of which the chief executive will be appointed *ex officio*. One will represent local government and one road users.

2.3 The proposal to give TNZ a majority on the Board should be reconsidered since it conflicts with the separation of procurement from provision. An alternative approach would be to have two members from TNZ and to provide for the appointment of an independent chairperson who would not represent any particular group in the industry.

The Principal Objectives of the Board and TNZ

2.4 The Board's principal objective will be "to allocate resources to achieve a safe and efficient roading system". Assigning responsibility for funding to the Board requires amending TNZ's objectives. Clause 11 of the Bill specifies that Transit New Zealand's principal objective "shall be to promote policies and allocate resources to achieve a safe and efficient State highway system". Under existing legislation TNZ's principal objective is "to promote policies and allocate resources to achieve a safe and efficient land transport system that maximises national economic and social benefits". The proposed statement of objectives for TNZ is a considerable improvement (for the reasons set out in the NZBR's earlier reports), and is consistent with the move to create a clearer provider objective for TNZ.

2.5 **Nevertheless, in the NZBR's view, both objective statements should be improved by explicitly or implicitly subsuming safety considerations within the efficiency objective.** Taken literally, the Bill's proposed statements fail because a totally safe system is unattainable. No one can be held accountable for failing to achieve the impossible. Even if they are not taken literally, the statements fail to impose accountability because they provide no indication as to how safe the road system should be.

2.6 Each entity should have a single objective - efficient allocation and efficient provision respectively. An efficient roading system will result from optimal trade-offs between costs and the various attributes of a roading system which users value such as safety, road surface quality, carrying capacity, passing lanes, air quality and road-related amenities. As with the other desirable attributes, it is efficient to increase safety only to the point where the marginal cost is no greater than the additional benefits to road users. Optimal safety considerations are thus accommodated in an efficiency objective. The inclusion of safety in addition to efficiency is either redundant or it reflects a view that it is necessary to spend more on safety than would be efficient. If the latter is the case, policy makers need to spell out how the Board and TNZ are to determine how much safety is optimal. The current objective statement creates an unresolved ambiguity which must reduce accountability.

2.7 Perhaps the current statement reflects a concern that some might interpret efficiency more narrowly, for example as a concept which does not necessarily encompass optimal safety considerations. However, such a concern could be addressed by explicitly specifying that the efficiency objective incorporates safety considerations. For example, if the government agrees that accountability is maximised if key entities have a single objective but wishes to avoid any misunderstanding about the safety aspect, it could replace the words "a safe and efficient ... system" in the above clauses by the words "an efficient ... system, with due attention to safety considerations".

The Functions and Powers of the Board

2.8 The proposed section 3C defines the powers and functions of the Board. These are very significant. The Board must approve a national roading programme which includes the road projects that the Board considers should be included (given its principal objective). It must review and revise this programme in accordance with its most recent performance agreement with the Minister of Transport (via TNZ); approve the competitive pricing procedures; audit the performance of TNZ and every local authority against their road programmes; and assist the Minister of Transport as required.

2.9 The proposed section 3B(3) states that the Board shall act independently of the Minister of Transport and of TNZ in determining what projects to include in the national roading programme and in making payments from the National Roads Account. Clearly this is an important and desirable provision.

The Annual Performance Agreement

2.10 The terms of reference for the Board's annual performance agreement with the Minister of Transport require it *inter alia* to set out the basis on which it will prepare the national roading programme; evaluate individual projects; approve competitive pricing procedures; and determine the minimum balance of the National Roads Account. Given its principal objective, it is hard to see how the Board can do other than use an efficiency basis for these purposes.

2.11 These provisions appear to be appropriate and to have considerable potential for making all expenditure allocation decisions subject to technical cost-benefit considerations which cannot be readily manipulated for project-specific, political purposes.

3.0 A Dedicated Fund for Road Expenditures

3.1 Part II of the Bill creates a dedicated fund for road expenditures. The aim is to eliminate the surpluses in the present Land Transport Fund by ensuring that all money collected *for roading* is returned to roading agencies as soon as possible (refer to the proposed clause 10(e)). The government will determine the rates at which road users are to be levied for road user charges, fuel excise taxes and motor vehicle registration fees as at present. The amounts collected will available for road expenditures, but can only be spent on approved projects. The government's ability to hold back some of the funds so collected will be substantially constrained. Note that the amounts collected for roading will be less than the total amounts collected from road users. For example, motor spirits excise duty is 32.2¢/litre, with lead tax an additional 8¢ per gram, but only 9.4¢/litre is allocated to road expenditure.

3.2 The intention of so constraining the current level of discretion is laudable. It is desirable to limit *ad hoc* government decision making and encourage future governments to take a structured, medium-term approach to funding expenditures on the road network.

3.3 Nevertheless, it is not logical to require that amounts collected from road users should always be spent on the road network. This is clearly not optimal for any activity. Funds should be spent on the highest return activity, regardless of the source of that funding. As long as governments retain ownership of the road network they will be responsible to taxpayers and ratepayers for obtaining value for money wherever that money is spent.

3.4 There will be periods when cash surpluses from road activities should be spent elsewhere and periods in which road expenditures should exceed revenues. The reason is that current period expenditures should be driven by current and expected future revenues. In contrast, with given road fees and charges, current road revenue will fluctuate with traffic volumes, possibly independently of future revenues. Optimal road expenditure plans should be driven by judgments about how permanent are those volume fluctuations, the degree of excess capacity in the relevant parts of the network and the state of (dis)repair of the network. Therefore it does not follow that current road expenditure should rise with every lift in revenue or fall with every drop.

3.5 During periods of strong revenue growth, it is conceivable that payments into the Board's National Roads Account ('the Account') will be greater than the pool of approved projects. In terms of the Bill, that would lead to an unspent balance in the Account. Such a surplus would put pressure on the Board to relax its project evaluation criteria (e.g. by lowering the discount rate or enhancing the assessed value of savings in road users' time). There appears to be no provision in the Bill for any branch of government to obtain such a surplus for non-roading purposes (e.g. see sections 15 and 16). Therefore the only way the government would be able to extract the surplus, within the confines of the proposed arrangements, would be to reduce roading revenues. Conversely, during recessions road revenue might slump. This could also create problems for the Board's project selection processes. The Board's ability to borrow could alleviate the situation, although this ability appears to be likely to be constrained by collateral and other considerations.

3.6 It would not be appropriate for the government to react to changing traffic volumes by changing unit charges, fees or rates of excise duty so as to keep current period revenues in line with optimal current period expenditures. For example, it would not be optimal to raise fees on current road users in order to fully fund heavy current period capital expenditures for the benefit of future users; nor would it necessarily be optimal to reduce charges to road users at times of low expenditure. Either approach would sometimes send the wrong signals to users who could be making important long-term, transport-related decisions (e.g. about industry location). Within the constraint of avoiding undue volatility in charges to end users, it would be possible for a government to adjust payments into the Account by adjusting the portion of petrol excise duty which is allocated to roading revenues. However, this is a crude mechanism for addressing the underlying problem, and could amount to little change from the status quo.

3.7 For these reasons the proposed changes seem likely to be contentious and even unsatisfactory in practice. If so they may not, in fact, give road users or infrastructure providers sustained confidence that predictable amounts will always be promptly available for optimal road expenditure decisions. This is not a criticism of the government; it is important that it does respond to the pressures on it to justify any arrangement which inhibits its ability to divert funds into activities in which the returns are the highest. While there is a genuine need to reduce unnecessary uncertainties in road funding, within a medium-term framework, it is not clear that the proposed dedicated fund provides the best approach.

4.0 The Land Transport Strategies

4.1 Part II of the Bill provides for the development of national and regional land transport strategies. The legislation will enable the Minister of Transport to prepare a national land transport strategy. The strategy may include statements of the Crown's goals such as safety, infrastructure, the environment, energy efficiency and services for the "transport disadvantaged". It would also be likely to include statements of policy objectives to achieve these goals and measurable targets. Such a national strategy could remain current for as long as 10 years. Regional councils would have to prepare regional land transport strategies which were not inconsistent with the national land transport strategy. These regional plans would be kept current for between 3 years and 5 years in advance.

4.2 Critically, for the reasons explained below, the national road programme (to be approved by the Board), the state highways programme (to be prepared by TNZ), and the regional and district roading programmes must all be "not inconsistent" with the national land transport strategy.

4.3 This measure is explained in the Ministry of Transport's March 1995 client newsletter as an administrative move to "pull together for the first time all the various goals relating to the land transport sector and put them in one place". This is no doubt indeed the case. However, the effect will be to focus attention on the many difficulties which surround any attempts to adopt a central planning framework for this sector - or any other.

4.4 We do not have a national banking system strategy with statements of Crown goals in respect of customer security, infrastructure, the environment, energy efficiency and services for the 'banking disadvantaged' - for good and obvious reasons. Centralised agencies do not understand bank customers' needs and cannot direct individual suppliers of banking services to meet government-determined needs rather than their customers' requirements. Less hypothetically, in past decades New Zealand has pursued centralised energy planning and the NZIER and the Treasury have both documented the cost to the nation of inappropriate and poorly timed investment decisions during those years.

4.5 Those involved in setting specific national objectives for the national land transport strategy will not have good information about user willingness to pay for safety, infrastructure, energy efficiency, environmental needs or services for the relatively immobile. They are likely to have multiple objectives and to be operating in an environment in which pressures to redistribute resources, rather than add to aggregate community welfare, are high. Accountability is likely to be diffuse.

4.6 Further, it is hard to see the case for separating land transport from other forms of transport or for taking a sector-specific approach to safety, environmental, and/or disabled issues. The last is a social welfare issue and the others are not industry specific, although the characteristics of the issues will vary across and within sectors.

4.7 Current arrangements suggest that safety has a separate dimension in respect of road transport. However, there are clear disadvantages in separating responsibility for safety from responsibility for the provision of infrastructure, as the NZBR pointed out in its 1993 report. Making the road infrastructure operator responsible for safety expenditures, including road rules and enforcement, would allow safety and infrastructure capacity and quality decisions to be optimised internally - based, no doubt, on externally-set requirements and assessments of customer and employee willingness to pay. This is what occurs in other risky industries. Undoubtedly, infrastructure operators would have to satisfy an external agency for the foreseeable future that their safety rules were appropriate and were being enforced. This would not be different in kind from the situation in many other inherently risky industries.

4.8 No doubt the drive for centralised indicative planning in this sector is a legacy of the heavy continuing government ownership of this sector. It is pleasing in this respect that air and sea transport are no longer subject to the same approach. On the other hand there is no obvious reason for including rail transport but excluding air or sea transport. The risks inherent in attempting to set national objectives for rail transport or urban passenger services appear to outweigh conceivable benefits.

4.9 The normal difficulty with central planning, namely that customers do not adequately value what central planners want an industry to provide, is less obvious when the Crown is making the purchasing decisions on the customers' behalf. Government ownership of the road network and the absence of a conventional billing system do create particular difficulties with determining user willingness to pay in respect of road-related expenditures. This problem is most acute for government procurement of road infrastructure services. However, there is no obvious case for a road infrastructure procurement issue to be treated as a land transport problem. Rail and road passenger services can be readily provided and tailored to user needs under present technologies without the dubious benefits of a national land transport strategy. Local communities can decide for themselves how much financial support to give the provision of local bus services. The government, through the Department of Social Welfare, can decide nationally what assistance it gives to those who have abnormal transport - or other - requirements which they cannot meet through taxis or other means. Similarly, just as the Ministry for the Environment does not need a national agricultural land strategy in order to determine optimal environmental policies for agriculture, neither does it need a national land transport strategy.

4.10 The above considerations suggest that the issue of a national land transport strategy in the Bill should be revisited with a view to restricting its focus to road transport, or even more narrowly to road infrastructure procurement issues.

4.11 Even if so restricted, in practice the setting of the proposed national goals for infrastructure procurement would be highly politicised, given the absence of good information about user willingness to pay. For this reason alone, it could well produce priorities which conflict with the more objective, efficiency-driven, project appraisal approach which the Board and TNZ would be obliged to use for project selection. Under the Bill, the Board and TNZ would be required to produce programmes meeting the objective[s] of [safety and] efficiency but also to be "not inconsistent" with politically-determined, specific national objectives. It is quite conceivable that this could be an impossible task.

4.12 Nevertheless, the Crown does need to have a process by which the Board is informed of its procurement priorities in respect of road infrastructure. Suppose, for example, that the Crown determines to spend money maintaining a more extensive, better quality, rural road network than could be justified on the basis of objective cost-benefit analysis (or even of willingness to pay). It would be good public policy for the Crown to transparently subsidise this activity, not necessarily at the expense of projects for other road users.

4.13 The Board would then proceed to determine the national road programme on the basis of the net subsidy-inclusive benefits which particular projects conferred. The integrity of the cost-benefit approach to project selection would be maintained. This would not necessarily be the case in the absence of an explicit subsidy. An explicit subsidy will also increase the transparency of decisions as to how this subsidy should be funded. Obviously it is not necessarily efficient for urban motorists to fund subsidies for rural roads.

4.14 Such transparency would protect the integrity of the project selection process (which very properly is set up in the proposed section 3C(3) of the Act to be independent of the Minister of Transport and TNZ). The payment of explicit subsidies to the Board for the procurement of infrastructural facilities would allow it to fund projects which would not otherwise pass the Board's project selection test. In the case of environmental issues, the subsidy might be negative (i.e. particular types of Board projects could be taxed).

4.15 The discussion in this section suggests that the Board and TNZ should not be required to simultaneously pursue an efficiency objective and to produce programmes which are "not inconsistent" with the national strategy. Instead, a transparent process should be put in place by which inconsistencies between the efficiency objective and the national strategy are identified and the government is given the opportunity to adjust the amount it is prepared to spend on procuring roading infrastructure in the light of the advice it receives as to what outputs can be purchased on the basis of existing funding intentions.

4.16 Implementing this suggestion would require amending the proposed sections 42B and 42E so that they require transparency of treatment of inconsistencies and a process for addressing them - rather than the absence of inconsistencies.

5.0 Local Government Reform Issues

In-House Professional Services and Minor and Ancillary Works

5.1 Clause 30 of Part I of the Bill provides that local authorities can be paid by the Board for the provision of in-house professional services at prices which do not have to be determined by the competitive pricing procedures set out in clause 29.

5.2 In stark contrast, the Bill determines that minor and ancillary works will be subject to such competitive pricing procedures in three stages. Section 34 allows the Minister of Transport to determine the organisational basis on which local authorities can compete for minor and ancillary work. The Ministry's March 1995 client newsletter on the Bill states that such local authorities will have to form a business unit or a LATE.

5.3 The NZBR is aware of the extensive debate between TNZ, local authorities and the consulting industry concerning the issue of competitive tendering for in-house professional services. The amounts involved are significant and it is interesting to note the observations that:

- only 21 percent of surveyed expenditure by territorial local authorities on roading professional services is contracted out;

- eleven territorial local authorities, mostly rural, place 60-100 percent of such work with external suppliers, with three contracting out all roading professional services;

- the proportion being contracted out is not increasing significantly, if at all;

- consulting services are available in all parts of the country;

- the 1989 TNZ Act required competitive pricing procedures to be applied to all state-funded or subsidised expenditure;

- this was consistent with other, still current, requirements of the Act that all work for state highways be contracted out; and

- as a transitional interim measure, the June 1991 amendment to the 1989 Act removed the requirement to contract out professional services.

5.4 In the NZBR's view, the potential gains from imposing mandatory competitive pricing procedures are likely to be significant. There is a clear conflict of interest between in-house purchaser and supply functions. This conflict raises greater concerns the less transparent are these arrangements and the weaker are the commercial disciplines applying to the overall organisation. Local authorities have only relatively weak incentives to vigorously control such principal/agent problems.

5.5 The interim decisions taken in 1991 reflected concerns about redundancy costs and the need for a longer transitional period. That time has now surely passed. The Local Authorities (Employment Protection) Act 1993 has been repealed and the Employment Contracts Act has now dealt with technical redundancies. In any case, redundancy costs do not justify special treatment of this sector. New Zealand industry generally has had to make major adjustments to its cost structures in the last decade despite redundancy costs. Sectors which have overstaffed and which fail to adjust because of redundancy agreements reduce community welfare because overstaffing represents an ongoing and avoidable waste of resources. In contrast, contractual redundancy payments do not reduce aggregate welfare but only transfer existing wealth. Local authorities should not be permitted to impose continuing cost excesses on the community simply because they do not wish to disclose to the community the liabilities which have arisen because of their past staffing decisions and redundancy arrangements.

5.6 There may be a case for some flexibility concerning the definition of professional services or in respect of any situations where the case for in-house provision is compelling. Neither of these potential difficulties appears to be of significance. The United Kingdom has moved strongly to impose competitive pricing in this area and several territorial authorities in New Zealand have demonstrated that 100 percent contracting out is feasible.

5.7 The NZBR strongly recommends that the Bill reinstates the provisions of the 1989 TNZ Act in respect of competitive pricing procedures for in-house professional services.

5.8 For competitive neutrality, it is important that local authority services enjoy no inherent tax, transfer pricing or other advantages compared with private sector competitors. This is likely to require units which wish to compete with private sector providers to form LATEs.

Regional Petrol Taxes

5.9 Clause 61 of Part V of the Bill allows regional petrol taxes to be continued indefinitely beyond their current expiry date of 30 June 1995.

5.10 Regional petrol taxes may be appropriate where a regional community determines that it wishes to fund a more extensive road infrastructure system than would otherwise be supplied and that it would be more efficient (and perhaps more equitable) to fund it out of petrol taxes than, say, rates, a local vehicle registration fee or a street parking fee.

5.11 However, the NZBR is not convinced that regional petrol taxes should be imposed on local motorists in order to subsidise bus or train services. The most efficient and arguably the fairest rule is that those who use a system should meet its costs. There is no obvious reason why those who use bus or train services should be subsidised by those, such as taxi passengers, motorists, pedestrians or cyclists, who do not - and vice versa. Any subsidy for commuter bus or train services can be funded out of rates. Funding the subsidy from motorists is likely to distort location decisions.

5.12 The NZBR favours retention of the 30 June 1995 expiry date until local authorities' incentives to tax efficiently have been strengthened and due consideration has been given to alternative ways of charging local road users for local services.

Auckland Bus Services

5.13 The NZBR considers that the Bill should be amended to remove the legal uncertainty which exists about the application of Part XXXIVB of the Local Government Act 1974 to the Auckland Regional Services Trust (the Trust). The Crown Law office, in a letter of 26 September 1994 to the Ministry of Transport, determined that there are "substantial and fundamental inconsistencies" between Part XXXIVB of this Act, which requires local authorities to divest their interests in passenger transport operations, and Part XLIVB of the same Act which applies specifically to the Auckland Regional Services Trust.

5.14 This uncertainty is entirely unintended. The Local Government Act 1994, section 594ZZB, required the public transport interests, undertakings and operations of each regional council to be divested by 30 June 1994 unless a later date was set by the Minister of Transport. In 1992 an amendment to the Act created the Trust into which the Auckland Regional Council passed its trading assets, including the Yellow Bus Company. The Trust's responsibilities included selling its shares "as soon as is practicable and prudent". The current Minister of Transport has confirmed as recently as March 1995 that "Part XLIVB was not intended to override the requirement to divest passenger transport assets as set out in Part XXXIVB". The date for divestment was extended to 30 June 1995 in 1993.

5.15 The NZBR understands that the uncertainty is putting the timing of the divestment in doubt. Given the potential gains for the community from privatisation - as illustrated in the case of Wellington bus services, for example - this uncertainty should be removed. It appears that it would be a simple matter to correct. For example, the Bill could be altered to include a clause which would amend the Local Government Act 1994 to provide that the requirements in Part XXXIVB could not be overridden by anything in (the appropriate sections of) Part XLIVB of the Act.

SUBMISSION TO THE FINANCE AND EXPENDITURE COMMITTEE OF THE HOUSE OF REPRESENTATIVES

ON THE

1995 BUDGET POLICY STATEMENT

NEW ZEALAND BUSINESS ROUNDTABLE
MARCH 1995

Summary

The New Zealand Business Roundtable (NZBR) strongly supports the government's plans to use increased revenues from economic growth first and foremost to generate operating surpluses, reduce debt and increase Crown net worth. The government's statement that it will not increase statutory tax rates and its care to avoid premature commitments to tax cuts are consistent with this approach and add to its credibility. The subsequent intention to reduce tax rates is also supported by the NZBR as making a further contribution to economic efficiency and growth.

The goal of running operating surpluses, at least until net debt is reduced to below 20 percent of GDP, is prudent in the current state of knowledge.

Less prudent are the decisions to increase discretionary government spending. The substantial savings in debt servicing that are projected are being offset by very significant increases in other spending. This is a risky strategy. It is very dependent on economic growth continuing at high rates. While the NZBR believes the projected growth rates are achievable with sound policies, the past record provides ample evidence of New Zealand's vulnerability to economic shocks. A cautious approach and tight expenditure control is therefore warranted. Fiscal discipline has made a large contribution to the improved state of the economy since 1991.

It is far from clear that the increased spending will contribute usefully, if at all, to social cohesion or why it should not be funded by reductions in other discretionary government spending. Spending programmes need to be justified by establishing that their benefits exceed their costs. Research indicates that the direct and indirect costs of raising a dollar of revenue can significantly exceed the benefits of a dollar of expenditure.

More disappointing, and of greater moment in dollar terms, is the government's strategy of pursuing its net debt targets through strong revenue growth rather than through a combination of revenue growth and significantly greater nominal and real expenditure reductions. The latter could be achieved through structural reforms and asset sales. Much government expenditure is of dubious merit and there is ample evidence of improved outcomes when responsibility for expenditure decisions is shifted back to the private sector. Failure to take harder expenditure decisions now, when growth prospects are reasonably favourable, puts the country at the risk of having to take those decisions in more difficult circumstances at a later date.

Economic growth, a key strategic priority, would also be enhanced if the 1995 Budget sought to reduce, where appropriate, the burdens which government regulations place on the private sector. Many regulations clearly impair private property rights, undermine the sanctity of contract and expose the private sector to the risks associated with unpredictable and sometimes disturbing decisions by regulators, courts, tribunals and boards of inquiry. While the Budget Policy Statement (BPS) was not required to spell out the intentions of the 1995 Budget in respect of regulatory polices, a review of these policies should be an important part of the forthcoming Budget.

Introduction

This submission on the Budget Policy Statement (BPS) of 23 February 1995 is made by the New Zealand Business Roundtable (NZBR), an organisation of 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.

The Fiscal Responsibility Act (the Act) requires the minister of finance to publish a BPS by 31 March each year. Section 6 requires this year's statement to specify the government's long-term objectives for fiscal policy and the broad strategic priorities for the three financial years commencing from 1995/96 which it will use as a guide in preparing the 1995 Budget. The BPS must comment on the degree to which these statements are consistent with the principles of responsible fiscal management specified in the Act, the reasons for any departures from those principles and the consistency of the objectives and intentions with those in earlier statements.

Section 2 briefly summarises the main features of the BPS. Section 3 comments on those features.

2 Summary of the BPS

Strategic Priorities

The government has set two major strategic priorities for the 1995 Budget. They are to increase economic opportunity and social cohesion. Economic opportunity is to be pursued by enhancing national economic growth through expenditure control and debt reduction. Social cohesion is to be enhanced by greater spending on social policies, finding a mechanism for resolving Treaty of Waitangi claims and better protecting the environment.

Long-Term Objectives

Key intentions are to:

- reduce operating expenses from 36 percent of GDP to below 30 percent of GDP, with the shorter-term goal of holding nominal expenses constant at around $31 billion for the three years to 1997/98;
- use the strong growth in revenues to run large surpluses until net debt is sustainably reduced below 30 percent of GDP, when tax cuts may occur if economic and fiscal conditions permit;
- maintain surpluses, despite any tax cuts, until net debt is reduced below 20 percent of GDP and at least balance the budget over the economic cycle beyond this point;
- achieve and build positive net worth; and
- reduce fiscal risks by retiring debt (most immediately eliminating net foreign currency debt) and divestment of commercial risks.

Appendix 1 summarises the long-term objectives and short-term fiscal intentions set out in the BPS. Appendix 2 summarises the fiscal projections contained in the BPS, but includes data on 1993/94 and 1994/95 taken from the December 1994 Fiscal Update.

Consistency with Earlier Statements

The BPS states that its long-term objectives are consistent with those presented in the long-term (30 June 1994) Fiscal Strategy Report, as are its 1996/97 and 1997/98 intentions for net debt, operating surplus, revenue and net worth. If debt falls below 30 percent of GDP sustainably and if macroeconomic conditions permit, taxes will be reduced.

It also observes that the revenue, expenditure and net worth projections have changed. Revenue is growing faster than expected and expenditure has increased by less than revenue growth. Net debt has been reduced by the sale of Government Computing Services, the Singapore Chancery and by the expected receipt of a special dividend approaching $600 million from ECNZ in 1994/95. Net worth has also benefited by $700 million more than expected in June 1994, mainly because of asset revaluations of state highways and specialist military equipment. The effects of these changes are shown in Appendix 2.

3 Comments on the Main Features of the *BPS*

Overview

The BPS provides a welcome opportunity for public consideration of the critical parameters driving the preparation of the 1995 Budget. Its required medium-term framework facilitates considered debate about budget strategy and priorities. The BPS also has a useful role to play in increasing the transparency and predictability of fiscal policies.

The NZBR strongly supports the government's intentions to use the increased revenues from economic growth first and foremost to generate operating surpluses, reduce debt and increase Crown net worth. The government's statement that it will not increase statutory tax rates and its care to avoid premature commitments to tax cuts are consistent with this approach and add to its credibility. The subsequent intention to reduce tax rates is also supported as a further boost to economic efficiency and growth.

The NZBR welcomes the confirmation provided by the BPS that the government remains determined to use the extra revenue generated by economic growth primarily to run fiscal surpluses until debt is reduced to more prudent levels.

The NZBR agrees that, in the current state of knowledge, the government should aim to run operating surpluses, at least until net debt is reduced to below 20 percent of GDP. Net debt was below 10 percent of GDP prior to the first oil shock in the early 1970s and there can be no strong presumption that the 20 percent figure, which was last achieved in the early 1980s after many years of heavy borrowing, is optimal.

The NZBR's greatest reservations arise in respect of the large ongoing role for central government envisaged in the BPS, whether measured by non-debt expenditures, total assets or intrusive regulations. These reservations are discussed below.

Government Expenditure

Total nominal operating expenses rise only fractionally between 1993/4 and 1997/98. Nominal GDP is predicted to increase by 24 percent, so total expenditure is projected to fall from 35.9 percent of GDP to 30.5 percent during the same period.

However, the fall would be greater if the government were not increasing discretionary spending markedly. Strong economic growth and fiscal surpluses should see total (real) expenditures fall appreciably, reflecting lower debt servicing costs and reduced cyclical spending (e.g. on unemployment benefits).

The December 1994 Economic and Fiscal Update projected that spending on health, education and social welfare would rise by $1.5 billion in the three years to 1997/98, while debt servicing costs would fall by about $1.5 billion. Demographic factors, indexation and discretionary increases primarily drive the increase in social services spending. Since December 1994, provision has been made for a further $100 million of operating expenses in 1996/97 and $200 million in 1997/98. Since the 30 June 1994 Budget, new policy decisions or provisions have increased operating expenses on average by around $600 million in each of the three years to 1997/98. Not included in the above figures is the provision since the December 1994 update for associated capital expenditures of $100 million in 1996/97 and $200 million in 1997/98.

These projections indicate that trends in social welfare spending are structural and demographic rather than cyclical. Numbers on the unemployment benefit are projected to fall by 23,000, but 9,000 more domestic purposes beneficiaries are projected, along with 10,000 more invalid beneficiaries and 3000 more sickness beneficiaries. The December 1984 update projected only a $170 million reduction from 1994/95 in payments for the unemployment benefit which was more than offset by increases in payments on the domestic purposes benefit ($192 million), the invalids' benefit ($94 million), the sickness benefit ($54 million) and smaller increases in the accommodation supplement and in special benefits. Clearly significant switching between benefit categories is occurring, and there are grounds for tightening up on administrative procedures.

Taxing more heavily in order to fund increased social spending is appropriate if all existing spending is justified in cost-benefit terms and if the benefits from the increased social spending exceed the costs. The BPS does not comment on either of these preconditions. Taxes impose a clear cost on the community because of their administrative and compliance costs and because they unintentionally, but inevitably, distort taxpayers' decisions. Research for the Institute of Policy Studies has found that administrative and compliance costs are substantial. While it is impossible to estimate precisely the full costs to the community of the distortions caused by taxes, research for the NZBR suggests that each dollar raised in taxation costs the community at least a further 14-18 cents. These estimates take no account of the corresponding costs associated with government expenditure programmes. Clearly those programmes may also have administrative and compliance costs and distort behaviour.

With tax revenues running at around 34 percent of GDP throughout the forecast period, such estimates indicate that government spending is imposing a heavy and ongoing cost on the community. All spending activities therefore face a burden of proof that their benefits exceed the costs. While any government must accept such costs if it wishes to tax one group in the community in order to fund another, it must ask itself if it is doing the community a service if a portion of those taxes are used to buy services for the same group that is being taxed. There are clearly lower costs for the community if relatively well-off individuals are permitted to make such purchases for themselves.

In its submission to the Finance and Expenditure Committee in February 1994 on the Fiscal Responsibility Bill, the NZBR proposed a statement of fiscal objectives which would include the objective of "limiting the burden of government spending by ensuring that government spending programmes produce benefits which exceed the cost to the nation of the taxes required to fund them" (refer to pages 5 and 43 of that submission). However, this objective was not included in the Act.

The BPS is not therefore required by the Act to establish net community benefits from government spending decisions. The BPS justifies the additional spending under its strategic objective of enhancing social cohesion. It is not clear how the government assesses the contribution of these projects to social cohesion nor how it concludes that the benefit to the community from greater social cohesion, achieved in this manner, exceeds the costs. Other government spending programmes no doubt contribute positively to social cohesion, as do private spending opportunities. It is not clear how the government has determined that the programmes under this heading are preferred and why they should be funded from the private sector rather than by cutting other government expenditure programmes which are deemed to be less socially cohesive. Similarly, some environmental protection objectives might be more effectively pursued through measures such as more economic pricing of roads, electricity and water supply than through increased government spending.

Although well-intentioned, social expenditures bring with them unintended and undesired side effects. They can induce state dependency, reward dysfunctional behaviour and sow dissatisfaction amongst taxpayers who perceive themselves to be less well off than some of those on welfare. The NZBR does not accept that society would be less cohesive if the government moved vigorously to improve the targeting of assistance programmes and to allow better-off individuals much greater scope to spend their own money on such things as education and health and to save for their own retirement, rather than have the government spend it for them.

A further factor to consider in respect of expenditure strategy is that the government is committing itself to increased discretionary expenditure in advance of the receipt of the expected revenue increases. It is difficult to imagine any period in the past when the government would not have forecast, in the medium term, a much stronger fiscal position than that which actually occurred. This is because expenditure forecasts always assume that there will be no new spending commitments or public sector wage growth, and that economic growth at existing tax rates will markedly increase revenue. Reality is all too frequently disappointing. New spending programmes materialise, tax cuts give back fiscal drag and/or a fall in the terms of trade reduces the rate of economic growth. Governments which do not seize the opportunity to cut back on spending during economic upturns commonly find that they must cut spending and/or raise tax rates during downturns. The BPS observes that the fiscal balance can shift by more than 3 percent of GDP in the economic cycle and cautions that the volatility might be greater than was previously thought (refer to page 5 of the BPS, footnote 1 in particular).

A more determined approach to reducing government expenditure would reduce the future burden of taxes and enhance the credibility of monetary and fiscal policies in the eyes of the business and investment community. Nor is such an approach incompatible with the government's income distribution objectives. The NZBR has commented on many occasions (for example in a 1992 report entitled *Budgetary Stress*) that there is very considerable scope for reducing the size of the government sector while preserving a social welfare safety net.

Taxation

The BPS states that the first priority for reducing the burden of taxation would be a reduction in income taxes for low to middle income earners and that the form of the tax cuts is to be examined this year. The NZBR supports the intention of reducing income tax ahead of GST as the deadweight (economic) costs of income tax appear to be higher, taxes on income penalise saving and the operation of the income tax is increasingly problematic in an open economy. In terms of the government's strategy of enhancing economic growth, the key priority should be to reduce taxes that impose the highest (deadweight) costs on the community. This could include reducing the high effective marginal tax rates associated with the phase-out of government assistance to those on low incomes but could also include taxes on capital income (especially tax on international income) and the top personal and company tax rates.

Asset Sales and Debt

The BPS is silent on the government's asset sale intentions. It merely notes (on page 18) that the government is committed to reducing commercial risks by divestment where appropriate. It contains no projections for total assets or total liabilities, but in any case it is not standard policy to account for asset sales in advance of the sale decision.

A vigorous asset sales programme would further reduce net debt. While this could reduce the burden of taxation if the reduction in debt servicing costs exceeded the loss of revenue from those assets, the more fundamental point is that many of those assets are likely to be put to much better use under private ownership. This applies particularly to such assets as electricity, forests, land and buildings and postal services. The scope for much greater private sector provision of health, education and roading services should also be examined.

As a small point, subsection 6(1)(d) of the Act requires the BPS to specify the Crown's intentions with respect to total Crown debt. The BPS does not do this. Instead it specifies the Crown's intentions in respect of net public debt. Neither section (4) nor section (6) of the Act mentions net public debt.

Net public debt is less than total Crown liabilities by the amount of the Crown's financial assets and by the amount of any Crown liabilities which do not constitute public debt. The latter includes the Crown's pension liabilities and payables and provisions. At 31 December 1994, the Crown's financial assets were $14.1 billion, total public debt was $45.9 billion and total Crown liabilities were $59.5 billion. Given that risks to the taxpayer arise in respect of all liabilities, it is important that the budget strategy does not focus unduly on just the net public debt component of those tax liabilities. For example, it is not clear why the Crown needs to sustain such a high level of overseas investments. It may also be possible to manage the Crown's pension liabilities better so as to reduce the risk of future policy changes which would transfer value from the taxpayer to current or future beneficiaries of the Government Superannuation Fund.

While the NZBR accepts that net debt is a relevant and practicable concept for projection purposes, the BPS should not permit a significant portion of the Crown's total assets and liabilities to escape scrutiny. The inclusion in the BPS of a risk management section helps guard against this possibility.

Government Regulations and the Cost of Business

The BPS focuses on reducing net public debt and controlling public spending in order to enhance economic growth. These are important goals, but government regulations can also inhibit growth by unduly raising private decision makers' costs and uncertainties.

Many government regulations significantly increase business costs and greatly reduce the certainty of private contracting. At a time of high unemployment, employment legislation and associated Employment Court decisions undoubtedly impair the ability of employers and employees to achieve certainty of contract and hence inhibit job creation. Farmers and others are experiencing uncertainties under occupational safety regulations. The Accident Compensation scheme is imposing actuarial liabilities on employers without allowing them the opportunity to control and manage those costs. The Resource Management Act creates many uncertainties and questionable outcomes for businesses. Uncertainties about the government's policies in respect of global warming, including the dubious decision to move from a no-regrets policy in which New Zealand would not move faster than other nations to the current commitment to

introduce a carbon tax depending on domestic outcomes alone, have been heightened by the recent board of inquiry decision in respect of the Stratford combined cycle power station. The interpretations being placed on the Human Rights Act by the Human Rights Commission and the Privacy Act's requirements are recent additions to the regulatory burdens on the business community.
The Act's principles of responsible fiscal management do not include a statement which would guard against an undue emphasis on Crown revenue and expenditures relative to regulatory policies. Consequently, section 6 of the Act does not clearly require the BPS to consider the degree to which regulatory policies may or may not contribute appropriately to the strategic priorities for the Budget which are required to be specified in subsection 6(3)(a) of the Act. (In its submission to the Finance and Expenditure Committee in February 1994 on the Fiscal Responsibility Bill, the NZBR proposed a statement of fiscal objectives which would include the objective of "ensuring that the above [budgetary] objectives are achieved without compromising the quality of regulatory or other policies, or the integrity of the Crown's accounting system" (refer to pages 5 and 43 of that submission).

The NZBR hopes that the statement on page 6 of the BPS that "[t]he key contribution of the 1995 Budget to sustain growth will be repaying public debt rapidly and preserving the potential for a substantial move to a lower tax rate structure in future" does not indicate a lack of resolve by the government to take action in this Budget to reduce the cost of regulations on business where it is appropriate to do so.

Appendix 1

Long-Term Objectives and Short-Term Fiscal Intentions and Budget Forecasts

	Long-Term Objective	*Short-Term Intention*	*1995 Budget*
Net Public Debt:	Get below 20% of GDP. [Projected for June 1998]	Rapidly achieve 20-30% of GDP. [Projected for June 1997]	Estimated to be 37.9% of GDP in June 1995 (43.4% in June 1994). Forecast to decline to 18.7% in June 1998.
Fiscal Balance:	Achieve at least fiscal balance, over the economic cycle, once net debt is below 20 percent of GDP. [Beyond 1997/98]	Run substantial surpluses. [To be achieved in 1994/95 and beyond]	Surplus of $2.6bn estimated for 1994/95 compared with $0.8bn in 1993/94. Surplus is forecast to rise to $3.3bn (1995/96), $5.4bn (1996/97) and $7.8bn (1997/98).
Operating Expenses:	Reduce to below 30% of GDP [Beyond 1997/98]	Reduce to 30.2% in 1997/98	Forecast to decline to 30.5% of GDP in 1997/98. Estimated to be 34.7% in 1994/95 (36.3% in 1993/94). Forecast to be 34.5% in 1995/96 and 32.7% in 1996/97.
Operating Revenues:	Broad-based, low-tax rate environment. No increase in statutory tax rates. Maintain tax base.	Tax cuts when economic and fiscal conditions permit. [From 1996/97]	No change.
Net Worth:	Restore to significantly positive levels.	Achieve and build positive net worth. [Achieve by June 1996]	Net worth is estimated to be a deficit of $3.1bn in June 1995. Positive net worth is forecast in June 1996 ($0.2bn) rising to $13bn in June 1998.
Risk Management:	Retire debt, divest where appropriate.	Eliminate net public foreign-currency debt.	Net public foreign currency debt is forecast to be eliminated by June 1997. Net public debt is forecast to decline from an estimated 37.9% of GDP in June 1995 to 18.7% in June 1998.

Note: Comments in square brackets indicate timing implicit in the BPS's projections.

Appendix 2

February 1995 Budget Policy Statement

$ Million	1993/94 Actual	1994/95 Dec-94 FU	1995/96 1994 Budget	1995/96 BPS	FSR/BPS Difference	1996/97 1994 Budget	1996/97 BPS	FSR/BPS Difference	1997/98 FSR	1997/98 BPS
Revenue	$30,183	$33,529	$33,527	$34,899	$1,372	$35,280	$36,583	$1,303		$38,128
Expenses	$29,639	$30,764	$30,970	$31,693	$723	$30,825	$31,798	$973		$31,206
Operating Balance	$755	$2,318	$3,069	$3,594	$525	$5,020	$5,182	$162		$7,427
Net Worth	($5,628)	($3,214)	($1,605)	$380	$1,985	$3,571	$5,562	$1,991		$12,989
Net Debt	$35,423	$33,445	$32,670	$30,014	($2,656)	$28,128	$25,362	($2,766)		$18,482
Implied GDP	$82,500	$88,839	$93,100	$93,424	$324	$98,100	$97,363	($737)		$102,328
% of GDP										
Revenue	36.6%	37.7%	36.0%	37.4%	1.3%	36.0%	37.6%	1.6%		37.3%
Expenses	35.9%	34.6%	33.3%	33.9%	0.7%	31.4%	32.7%	1.2%		30.5%
Operating Balance	0.9%	2.6%	3.3%	3.8%	0.6%	5.1%	5.3%	0.2%		7.3%
Net Worth	-6.8%	-3.6%	-1.7%	0.4%	2.1%	3.6%	5.7%	2.1%		12.7%
Net Debt	42.9%	37.6%	35.1%	32.1%	-3.0%	28.7%	26.0%	-2.6%		18.1%
% Change, Previous Year										
Implied GDP		7.7%	4.8%	5.2%	0.4%	5.4%	4.2%	-1.2%		5.1%
Revenue		11.1%	0.0%	4.1%	4.1%	5.2%	4.8%	-0.4%		4.2%
Expenses		3.8%	0.7%	3.0%	2.4%	-0.5%	0.3%	0.8%		-1.9%
Operating Balance		207.0%	32.4%	55.0%	22.6%	63.6%	44.2%	-19.4%		43.3%
Net Worth		-42.9%	-50.1%	-111.8%	-61.8%					
Net Debt		-5.6%	-2.3%	-10.3%	-7.9%	-13.9%	-15.5%	-1.6%		-27.1%

Sources: December 1994 Economic and Fiscal Update (pages 65 and 189) and the BPS (page 11).

SUBMISSION ON THE ECONOMIC POLICIES OF THE ALLIANCE

NEW ZEALAND BUSINESS ROUNDTABLE
NOVEMBER 1994

ECONOMIC POLICIES OF THE ALLIANCE

1 INTRODUCTION

This paper summarises and comments on the current form of the economic policies of the Alliance. These are continuing to evolve. The party has indicated that input from the business sector and other groups may be taken into account in developing its economic thinking.

This evaluation largely draws on the paper entitled *Alliance Economic Policy Design: A Discussion Paper to Foster Understanding between the Financial and Corporate Sectors and the Alliance.* The paper was sent to the New Zealand Business Roundtable (NZBR) in September and is referred to below as the 'September paper'.

2 A SUMMARY OF ALLIANCE ECONOMIC POLICIES

2.1 Economic and Social Objectives

The Alliance states that its economic policy has three broad dimensions or aims:

> "(i) Distribution of income, wealth, opportunity and activity between different social groups.
>
> (ii) Development of society over time in terms of both quantity and quality. Not just in terms of growth of existing goods and services but also in terms of the introduction of new possibilities for people.
>
> (iii) Efficiency of resource use including the elimination of waste and the replacement of non-renewable resources the supply of which would be increased by greater care of ecological processes."

The Alliance believes that current policy:

> "... is based on the individualistic view that requires a minimal state, weak trade unions, low taxes, a balanced budget and, theoretically, an anti-monopoly policy. Under such a view economic and monetary policy aims to ensure that resource allocation is as efficient as possible. This usually means that markets dominated by private interests are allowed to operate relatively freely to distribute incomes and wealth, to determine the way that the economy develops and to allocate resources."

By contrast the Alliance's approach:

> "... is based upon a cooperative idea which requires that the state ensures fair shares for all and that welfare and tax policies aim to look after all citizens. This view allows the citizens of a country to have a say over the distribution of income and wealth, over the course of economic development, over resource use and what kind of society they want to live in. In order to make the views of the citizens effective the state develops methods of managing the conditions that could lead to the achievement of all three aims [listed] above."

The Alliance recognises two further broad policy aims that arise from policy constraints. They are:

"(i) All economic development should be environmentally sustainable;

(ii) All economic development should lead to appropriate social development."

The main objectives or targets of the Alliance's economic policy are:

"- That the economy develops as quickly as possible;

- To ensure that full employment is achieved with emphasis given to activities which are job-rich, resource-efficient and low in pollution;

- With as low inflation as possible;

- Without balance of payments imbalances;

- Without incurring rising Central Government debt."

The Alliance notes that the government may wish to establish quantified targets, for example for growth, unemployment and inflation.

Measured against its aims, the Alliance assesses present performance in the following terms:

> "The distribution of income, wealth, opportunity and activity in society is increasingly unequal. The economy appears to be regressing towards increased commodity production and increased importation of sophisticated goods and services. There are even some indicators of inefficient resource use; capital productivity is falling and there is huge waste in terms of unemployment and despoliation of the environment."

2.2 Specific Policies

Key policies of the Alliance relate to the following areas:

Monetary and exchange rate policy

The Reserve Bank Act would be amended to broaden the functions of the Reserve Bank, to repeal the requirement for monetary targets to be fixed by agreement between the government and the governor, to revoke monetary policy targets, and to require the Reserve Bank to have regard to government economic and social policy in formulating and implementing monetary policy. The Alliance states in questions and answers attached to the September paper that it would "use all economic tools, including management of the exchange rate, to promote its overall objectives." A draft Bill attached to the Alliance paper would confer authority on the Reserve Bank to control prescribed interest rates.

Fiscal policy

The September paper does not explicitly address government expenditure, although additional spending on employment programmes, education and some other areas are noted. Earlier statements suggest that substantial new expenditure is also planned on social welfare, health and housing.

There is a commitment to a budget that is balanced over the economic cycle (excluding certain self-funding projects). The Alliance's indicative income tax policy includes the exemption from tax of the first $3,200 of income, a maximum marginal tax rate of 49 percent and a company tax rate of 40 percent. The superannuation surcharge would be abolished.

An ad valorem financial transactions tax (FTT) is to be applied to withdrawals from registered banks.[1] FTT is to replace GST. The alleged regressive nature of GST is given as the main reason for its planned demise. Resource rentals and specific consumption taxes, such as a carbon tax, will be applied to promote environmental objectives. User charges, including the ACC levy, would be abolished.

The maturity profile of foreign debt is to be lengthened and a sinking fund is to be established from current taxation so that foreign debt can subsequently be repaid on maturity.

Trade policy

The Alliance will argue for "fair" rather than "free" trade. The selective use of import controls, mainly in the form of targeted tariffs, is proposed. They are intended to protect certain sunrise industries, to uphold environmental standards, product quality and durability, and to prevent dumping of imports which undermine jobs or are produced through exploitative social and labour conditions.

Labour market

The achievement of full employment is described as the Alliance's most important policy aim. Its submission to the Employment Task Force goes further and recommends that full employment should be the main aim of economic policy. The submission suggests that it may take 10-12 years to achieve full employment.[2]

The Alliance would fund "job-rich projects" such as roading improvements and school and hospital maintenance. The longer-term strategy on unemployment is to encourage the development of new industries, including the establishment of an Economic Development Fund, and to assist with the establishment of Regional Development Agencies.

Training policies include the abolition of tertiary fees and means testing of student allowances, the phase-out of the Training Opportunities Programme (TOP) (which is to be replaced with vocational training at strengthened local education facilities) and a requirement on large employers to provide a specified number of trade training places.

The Employment Contracts Act is to be replaced with legislation that encourages collective bargaining. Legislation is to provide for a minimum set of wages and conditions, pay equity, equal employment opportunities and greater worker participation.

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1 It is unclear whether FTT would apply to withdrawals from financial institutions other than registered banks.

2 Full employment is defined as "Full participation in, and belonging to, society by all its members with an adequate income and a rising standard of social well-being for all." This definition of employment is unusual. It is similar to the basis on which the government was advised to set benefit levels by the 1972 Royal Commission.

Asset sales

There will be no sales of strategic assets. "A sustainable economy demands government control of our national resources and assets." The sale to foreigners of private and government strategic assets such as farmland, islands and areas of cultural and recreational interest will be "prevented". "[S]trict rules of social accountability will be required of all institutions or corporations which command strategic assets."

The Alliance's policies would be implemented progressively.

3 COMMENT

3.1 Policy Objectives

The Alliance is committed to rising incomes and employment levels, low inflation, a sound balance of payments and lower foreign debt. There is considerable agreement among the main political parties on these broad economic goals but significant differences on the means by which they are to be achieved and on the pace of adjustment.

The overall performance of the economy is critical to the achievement of all economic and social goals. The policy prescription for a high income economy is well established and accepted by mainstream public policy advisers, including institutions like the IMF and the OECD. It requires a credible commitment to price stability and small budget deficits, the avoidance of excessive government spending, taxes and regulation, and an economy that is open to international trade in goods, services and capital. The Alliance policy appears to include some elements of the required prescription but lack others. Its spending, tax and regulatory policies and its commitment to an open economy, especially foreign capital inflows, are most in doubt.

3.2 The Roles of Markets and Governments

The Alliance has an inadequate appreciation of the role of markets in a modern open economy and, as a consequence, it places excessive trust in the efficacy of government action. Markets are not impersonal institutions; they are simply structures within which ordinary New Zealanders transact with each other to their mutual advantage. With markets people have a direct say through their spending decisions. The significance of markets lies in their ability to coordinate complex activities and to convey information. For most economic activities, markets are the most efficient mechanism for carrying out these tasks.

A key role of the government is to set the rules within which markets are able to operate. Governments must allow people the freedom to take decisions within those rules if they are not to supplant people's ability to run their own lives. They should not distrust the capacity of ordinary people to make decisions in their best interests.

The appropriate roles of markets and governments will need to be discussed with the Alliance. In each case the interests of all members of the community are ultimately involved. The key issue is to determine where their interests are best served by direct decisions in the market place and where they are best served indirectly by voting and political action. The weaknesses of voting and political mechanisms are often greater than market imperfections.

3.3. Macroeconomic Policy

The NZBR has endorsed a strong commitment to price stability and a credible policy for its achievement. Any moves to target monetary policy at other economic objectives, such as full employment, or to adopt a less transparent approach to policy formulation would be detrimental to economic performance. Wholesale interest rates could be expected to rise, which would affect mortgage rates, and investment would be discouraged.

The suggestion that the government would manage the exchange rate, if necessary, should be viewed with considerable concern. Even large governments that directly intervene in the foreign exchange market are unable to withstand market pressures for long. The highly predictable result would be substantial losses which would fall on taxpayers, including those on low to moderate incomes, and increased uncertainty.

The Alliance seems to be of the view that a strong exchange rate is undesirable. Economies that perform well generally have firm currencies. A rising exchange rate (that is not artificially boosted by inappropriate policies) is one means by which productivity gains can be shared and the income of New Zealanders can increase relative to that of citizens of other countries. A devaluation of the currency which is effective (i.e. which changes New Zealand's competitive position) is equivalent to an across-the-board real wage cut. A currency depreciation also lowers the value of New Zealand's assets, making them cheaper for foreigners to purchase, thus running counter to the Alliance's concerns about national sovereignty.

3.4. Government Expenditure, Revenue and Assets

A major weakness in the Alliance's September paper is the absence of discussion on the overall level of government expenditure. In earlier announcements, the Alliance proposed substantial additional expenditure. Unless the benefits of new expenditure outweigh its costs, including the deadweight costs of related taxes, overall welfare is reduced. A recently published NZBR study showed that the deadweight costs of taxation are large.

The question of whether the Alliance's tax proposals would generate sufficient revenue to cover its expenditure proposals and its commitment to a balanced budget needs to be examined very carefully. The merits of introducing a FTT on distributional grounds and in place of GST are doubtful. The proposed test of the tax would be very costly for firms and the government because the FTT would need to be close to fully developed before the trial could start.

The Alliance has not announced a Fringe Benefit Tax (FBT) rate. If the rate of FBT were to be set on the basis of the top personal tax rate as is the case at present, it would rise to 96 percent. On the basis of the present rules this rate would also apply to those paying taxes at lower rates. The level at which other rates of income tax would be set has not been announced.[3]

While the September paper mentions asset sales, the management and performance of SOEs, Crown Entities and government departments are not discussed.

3 The key rates are the superannuation contributions withholding tax (currently 33 percent and set equal to the non-grossed up rate of FBT), the superannuation schemes and trustee income rates (33 percent), the life insurance policyholders' rate (33 percent and linked to the individual rate of tax) and the life company rate (33 percent and linked to the ordinary company tax rate).

3.5. Unemployment

The income of most people arises from employment, including self employment. Concerns about the distribution of income have been accentuated by an unacceptably high level of unemployment. In her study for the NZBR which was prepared as a contribution to the Prime Ministerial Task Force on Employment, Professor Judith Sloan stated that "Unemployment is not an international phenomenon - witness the spectacular economic successes of the newly industrialised countries of East Asia and of Japan." Professor Sloan also wrote "The causes of unemployment are well understood, with labour market inflexibilities and perverse welfare incentives being the main culprits." In her view "unemployment is essentially a political choice." Professor Sloan argued that unemployment would be likely to fall to around 4 percent by 1999, if present policies are maintained and certain plausible assumptions hold.

The Alliance has a pessimistic view on New Zealand's ability to achieve full employment. Its submission to the Task Force on Employment envisages an excessively long period (10 to 12 years) to attain full employment (although its definition of full employment is unusual). Many of the Alliance's labour market and social policies, such as higher welfare benefits and the abolition of the Employment Contracts Act and its replacement with collective bargaining and other regulations, constitute the sorts of policies identified by Professor Sloan as the prime cause of current unemployment.[4]

Notwithstanding short-term work programmes, the adoption of full employment as the central objective of economic policy, support for new industries and some emphasis on vocational training, the Alliance does not appear to have a feasible policy for reducing unemployment.

3.6 Redistributive Policies

There is excessive emphasis on redistribution relative to wealth creation in the Alliance's policies. The overall performance of the economy in raising living standards will have a far greater influence on the levels and distribution of income and wealth than redistributive policies. National income will increase by almost 50 percent in the next 10 years if the economy grows at an average rate of 4 percent a year. It is inconceivable that redistributive policies, which are often detrimental to growth, could provide a superior outcome.

The statement that the distribution of income, wealth and activity is becoming more unequal is at best unproven. There are no statistical studies in this area that would withstand close scrutiny. Unemployment has had the most adverse effect on income distribution in the last few years but it is now declining. Since June 1991, when the economy stopped contracting, 82,600 jobs have been created. It is not at all clear that income differentials are still widening, and a narrowing of the gap can be expected given continuing strong employment growth.

A number of the Alliance's policies are clearly regressive. These include the scrapping of tertiary fees, the abolition of means testing of student allowances and the superannuation surcharge.

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4 Higher benefit rates were included in earlier announcements but were not discussed in the September paper.

4 CONCLUDING COMMENT

The ideas and policies of all political parties should be taken seriously. They should be scrutinised in the interests of promoting better policies and informing voters. For these reasons, the NZBR welcomes the opportunity to engage in a constructive dialogue with the Alliance. There are some indications that the Alliance has modified its policy stance in response to recent comment and it has indicated that its policies will be subject to further refinement.

While the NZBR supports many of the objectives that the Alliance and other parties propose, there are considerable differences on the best means of achieving them. Ongoing evaluation of Alliance policies should focus in greater depth on:

- the importance of overall economic performance to the achievement of all economic and social goals;
- the appropriate roles of markets and governments in the economy;
- macroeconomic policy, including monetary and exchange rate policy;
- the efficacy of expenditure and tax proposals;
- policy on SOEs, Crown Entities and the management of the public sector;
- feasible policies to achieve full employment;
- income and wealth distribution;
- the benefits of an open economy; and
- the best means of achieving desirable environmental goals.

MISCELLANEOUS SPEECHES AND ARTICLES

U3A

REFLECTIONS ON OLD NEW ZEALAND

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

AUCKLAND
31 JULY 1995

REFLECTIONS ON OLD NEW ZEALAND

In preparing this talk, I recalled a letter to the editor of the *Dominion* in 1992 which had impressed me. It was entitled "What the 'oldies' have put up with" and read in part as follows:

> I have been a superannuitant for 18 years, and have lived and worked all my life in New Zealand.
>
> Many people do not seem to appreciate the difficulties and problems we "oldies" had to put up with during the past 30 or 40 years.
>
> First, we had to endure the difficulties of full employment for most of our adult lives. ...
>
> We condoned the entry of "gangster" unionism and did not object because we did not want our delightful lifestyle interrupted.
>
> We also had to endure the family benefit, free dental treatment for our children, free kindergartens, supplementary meat prices, subsidised fertiliser, subsidised television licences and telephones, free health, free hospitals, free medicine.
>
> It was most distressing and tiresome.
>
> We did not have time to supervise the discipline and education of our children so we handed that responsibility to Dr Beeby and his playway system of education, and we have been playing with education ever since. ...
>
> Some of my fellow superannuitants say we are entitled to our superannuation as a right because we have paid for it through taxation.
>
> What rubbish!
>
> We borrowed most of the money to pay for all these privileges (sic) that we voted for and now we still want to present the bill to the next generation.

From someone approaching 80 years of age, I found this a refreshingly honest reflection on the way we were. It contrasts with what MP Bill English recently described as the increasing arrogance of elderly people's organisations. To listen to Mr George Drain, you would never guess that the 'good old days' were those in which we became consistently poorer relative to the rest of the world for over fifty years, amassed a mountain of debt and a raft of social problems, and by 1984 were close to putting control of our destiny into the hands of the IMF.

Much of the political debate of the last ten years has been about the economy and the way we had mismanaged it. This is understandable as our situation had indeed become parlous. From having an average income per head around 92 percent of the US level in 1938, we had slid to 50 percent by the mid-1980s. Japan, with a per capita income under 20 percent of the US level in 1950, had already overtaken New Zealand by the early 1970s. With only one or two exceptions such as Argentina, no country had suffered such a precipitous fall.

Having a sound economy is certainly indispensable to achieving better living standards, the alleviation of poverty and many other goals that most people share. But economics is not the whole of life, and there are many other ways of looking back on New Zealand's experience. Some of them illuminate what we have viewed as largely economic issues in interesting ways.

To illustrate what I mean, let me take first the issue of inflation. As most people now appreciate, years of high inflation did enormous damage to the New Zealand economy. However, a former chief economist in the Reserve Bank of Australia recently made a point that I found compelling. He said that he discovered after arguing for twenty-five years against inflationary policies that the most powerful argument to use was a moral one. Inflation is basically dishonest money. As prices go up, you are cheated of the value of a dollar note or coin. A 10 percent rise in prices each year is enough to slice the value of that dollar to less than a cent within a working life of fifty years. Inflation redistributes income in all sorts of hidden ways. Although the general community is worse off, some people gain while others lose. And, as Keynes once said, not one person in a thousand realises what is going on.

Given the essentially immoral nature of inflation, where were our moral guardians in all the years when prices were rising at double digit rates? I don't remember those of us who were footsoldiers in the battle to persuade governments to abandon inflationary policies getting much help from them. And for that matter, where are they today? We still have politicians who are soft on inflation - some of them, ironically, posing as defenders of the interests of retired people. Those on fixed incomes would be among the hardest hit if inflation took off again. Savers are now getting an honest deal in New Zealand. There is a strong moral argument for the Reserve Bank Act, and it is perhaps fitting that the son of a minister of the church is presiding over it.

But savers were by no means the only group that got a raw deal in old New Zealand. Consider the way we used to treat consumers. I well remember presidents of the Manufacturers Federation calling on ministers in the 1970s and telling them they realised consumers didn't have much choice of imported products but what they had was good enough for them. In those days, you'll recall, we used to call import licences a licence to print money. Much of New Zealand's inherited wealth was based not on open competition in producing goods and services that consumers wanted but on holding licences bestowed by political favour. Again, was this a moral way to run a country?

All the old protectionist arguments were trotted out to justify telling consumers who were critical of over-priced and shoddy New Zealand manufactured products that they could like it or lump it. There are still echoes of those arguments around the world today. As Thomas Hazlett of the University of California wrote earlier this year:

> Of all the inanities spouted in the recent "debates" over NAFTA and GATT, the most outrageous - a very competitive title - concerned the contempt with which Americans on the left (Jerry Brown, Ralph Nader) and right (Ross Perot, Pat Buchanan) dismissed "cheap foreign labor."
>
> The exploitable populist fear underlying every advance of international commerce is the threat that somewhere, in a place far different from our own, people far different from us will rise up and take our jobs. We will be helpless, hapless, superfluous - these people will eat dirt for dinner, sleep standing up and produce twice what we can at one penny a day. How can we possibly compete against these alien life forms?

The lack of economic logic of this mercantilist argument was exploded long ago by Adam Smith. Smith pointed out that it was comparative, not absolute, economic advantage that mattered in international trade and that all countries could gain by free exchanges. However, Hazlett went on to make the point that:

> ... what is ugliest about the 'cheap foreign labor' argument is its utter brutality. Scratch the surface of the (flawed) economics and you arrive at a horrendously inhumane moral supposition: Screw those poor bastards - they'll outcompete us just for a meal!

Only a few years ago, CTU president Ken Douglas was expressing concern about low wages in the free labour market of Hong Kong. He hadn't noticed that Hong Kong had outstripped New Zealand: its per capita income in 1993 was US$18,060 compared with US$12,600 in New Zealand. Even more ironically, Hong Kong manufacturers are now contracting out work to 'cheap labour' countries like Australia. A recent issue of *Asia Inc* quotes Warwick Meyers, a leading Hong Kong tailor, as saying he can get his suits cut at a better price in Brisbane these days than he can in Kowloon.

The disregard of consumer interests, the lobbying for government privileges, and the 'she'll be right' attitude to quality permeated New Zealand business life. An executive of Lion Nathan recently described the liquor industry prior to deregulation in the following terms:

> The industry was a vertically integrated duopoly with incredible barriers to entry. The two entrenched players produced a mediocre product and treated the consumer with arrogance and contempt, in a manner that was supported and sanctioned by legislation. Since deregulation we have had to learn the hard way about our customers. We have had to restructure our businesses with the customer at the centre ... . And you know what: we are better for it, and so is our product and our profitability. It has been, and is, 'win-win' all round.

Given everything my chairman, Douglas Myers, and the Business Roundtable have done to promote an open, competitive economy in which customers' interests come first, it is bizarre, and frankly objectionable, to hear accusations about promoting the interests of 'big business.'

Of course, there was a funnier side to the way we used to run things. I remember the arch-controller, Sir Robert Muldoon, being temporarily taken aback at a meeting when he discovered that New Zealand issued import licences for jumbo jets. He turned to the Secretary of Trade and Industry, Harry Clark, and said:

> But Mr Clark, we don't have an industry that makes jumbo jets. People don't bring jumbo jets in unless they have a need for them. They're like elephants: elephants don't compete with cows, and you don't see surplus elephants in parking lots waiting for buyers. We don't have import licences for elephants, do we?

And Mr Clark's reply was: "I'm sorry to have tell you, prime minister, but we do license imports of elephants."

Why did we put up with such nonsense - with being the closest equivalent to the repressive and ramshackle economies of Eastern Europe - for so long? Partly, I suspect, it was because many of us had known nothing else. I remember going to Brussels as a New Zealand diplomatic representative in 1970 and experiencing the shock of living in a country where you could exchange currencies freely and import goods across borders without a permit. Here was a new dimension of freedom I had never experienced.

A few years later I remember staying with friends in Washington and suddenly realising at midnight the day before my departure that I hadn't bought something the kids wanted. "No problem," they said, "we'll go down to the local mall ." What struck me at 2.00 a.m. in the morning in suburban Washington was not just that the shopping mall was open but that amongst a vast range of goods were rows and rows of telephones. At that time New Zealand shopping hours were totally regulated and the Post Office supplied one type of phone - which you could get after a wait of about six weeks if you were lucky.

Another feature of the 'good old days' was the way we used to treat workers. People, you will recall, were not even free to sell their own labour to an employer. They had to join a union, and they didn't have a choice of union to join. As a result, protected unionists became as arrogant towards workers as protected businesses were towards consumers. To the extent they looked after anyone other than themselves, it was typically their white, male, full-time members at the expense of the interests of women, Maori, part-time workers and the unemployed.

Unionism of the kind that plagued countries like New Zealand, Britain, Australia, Argentina and Poland this century did immeasurable damage to the interests of workers. It kept wage growth far below that of countries such as Hong Kong, and in time led to endemic unemployment. Industrial mayhem brought industries like the meat and coal mining industries virtually to their knees, and the overweening political power that unions came to exercise subverted the democratic process.

An even worse aspect of the way government policies treated workers was highlighted a few years ago. Alan Gibbs, then chairman of the Forestry Corporation, once spoke of redundant forestry workers becoming free to do something useful with their lives. That remark may sound callous to you at first, but it is profoundly true.

We can all understand that if you pay someone to dig a hole and fill it in again, you are creating nothing of real social value. Yet that is exactly what we were doing when we 'employed' people in highly protected manufacturing firms doing things like assembling television sets which Japanese firms had been paid to dismantle before shipping them to New Zealand. It was the same story with highly subsidised activities like marginal forestry, or overstaffed government departments like the railways or the Post Office. The former Soviet Union and Eastern Europe are still coming to terms with the moral horror of the fact that many of their citizens spent their entire lives in sham jobs. They only had one life, and they wasted it. We did the same thing to thousands of decent New Zealanders. Because of our crazy policies, and without even knowing it, they spent much of their lives working hard at jobs that added nothing to New Zealand's real income. These artificial forms of employment cost jobs elsewhere in the economy which would have been more productive and rewarding.

A final group worth considering is taxpayers. I am not one who believes that taxation is theft. There are a range of functions that need to be undertaken by governments, and taxes are needed to fund many of them. But taxation is not the measure of compassion either. As the black economist Walter Williams has pointed out, 100 percent taxation is tantamount to slavery. At a tax rate of 100 percent you may as well be indentured. You are no longer free to enjoy any of the rewards of your own labour.

Tax rates in New Zealand used to be quite modest but grew steeply in the last thirty years. Budgets in the 1970s used to contain passages like this (as a random example I quote from Mr Tizard's budget of 1975):

> Some goods not previously subject to sales tax will become taxable, also with effect from midnight tonight. These are -
>
> Cuff-links, studs, or similar accessories; combs and hairslides; copying machines: 40 percent;
>
> Thermometers other than for industrial, scientific, or clinical use: 30 percent;
>
> Automatic vending machines other than petrol vending machines: 20 percent.

These goods were selected, incidentally, because they were not included in the CPI - another example of the kind of electoral fraud practised by past New Zealand governments.

Under Sir Robert Muldoon, the marginal rate of personal income tax reached 66 percent. Even today, the combination of tax and benefit abatement rates is often around 100 percent for a range of income. Such taxes are not only damaging to the economy but also to the economic opportunities of those who face them. They are rightly called poverty traps.

Of course, high levels of taxation usually have only one cause, namely high levels of government spending. Most of the growth in government spending in recent decades has come from social programmes, especially welfare. Moreover, much of the growth has occurred in the last thirty years. Members of the Labour government of the 1930s, for example, would be horrified at the scale of today's welfare state. Saint Michael Joseph Savage and his colleagues were not big spenders by today's standards. As one of the left-wing intellectuals in that government, Ormond Wilson, put it in the early 1980s: "The paradox today is to reflect on how modest were the changes actually carried through ... ." In 1951, for example, old aged pensions absorbed 2.8 percent of GDP compared with today's figure of around 6 percent.

David Thomson of Massey University has documented in *Selfish Generations* how voters in the years after 1938 arranged large-scale transfers to their advantage and at the expense of others, particularly the young. He points out that sound insurance principles in intergenerational contracts were nowhere observed, and those reaching old age this decade and next will be the very group which has failed most badly to play its part in exchanges to date. Part of this legacy is the huge debt burden run up in the 1970s and 1980s which current workers have to repay. There is nothing we can do about it now, other than make sure we do not repeat the mistake.

Looking back, it's extraordinary to remark on the silence from the 1960s to the early 1980s of many of those who profess to care about the poor, the welfare of future generations, and morality in political and economic life. Those were the years in which New Zealand lived grossly beyond its means, inflated away the incomes of savers, and borrowed at the expense of the future. Unemployment and poverty were highly visible by the time of the 1984 Economic Summit; Jane Stevens of the Unemployed and Beneficiaries Movement was one of the most prominent participants at that event. If we had not changed direction radically, the problems today would have been far more serious.

What has happened since 1984 is only a start, and was not all well executed, but the reforms have now delivered a robust economy in which there is real hope for our children and, incidentally, for the security of those in retirement. Instead of letting our destiny slip away on us, we are regaining it by becoming a competitive, flexible economy which is well on the way to restoring full employment and prudent levels of debt. Moreover, as the economist and former divinity student Paul Heyne said on a visit last year, the reforms:

> ... increase the freedom of individuals to pursue projects that interest them and reduce the amount of bureaucratic control over people. I think that's an important moral consideration.

Traditionally the church is an institution that has warned against the dangers of the regulatory and welfare state, and stressed individual and community responsibility. It was an important influence in throwing off the collectivist yoke in Eastern Europe. Most of its leaders in New Zealand comprehensively lost the plot, however, in bitterly opposing our own economic changes. It is pleasing to see that some of them are reappraising their position. Anglican Archbishop Brian Davis, for example, recently affirmed "very strongly the government's success in terms of economic strategy". He went on to say that, far from regarding the Employment Contracts Act as "sinful", he thinks it is working pretty well - with the qualification that it's still too difficult for an employer to get rid of bad or irresponsible workers.

We may hope that members of the church and related groups will increasingly join the consensus behind present policies and push for further improvements. There are still too many people around whom I would call "dangerous Samaritans" - people who can't be faulted for the genuineness of their compassion but who promote policies which would make the problems they are concerned about immeasurably worse. Expressions of compassion and solidarity with the disadvantaged become self-indulgent when they are not allied to credible programmes by which those disadvantaged can rise to self-sufficiency and self-respect. We must move beyond rhetoric and promote a better public understanding of what constitutes good economic and social policy.

What has happened in the last thirty years is not that people have changed their ideas about the goals of a good society. It's that people like Alan Gibbs, who were ardent socialists in their university days, have been forced by overwhelming evidence to change their ideas about the means of achieving those goals. Despisers of the market system once held the moral high ground. "From each according to his ability, to each according to his needs" sounded much kinder and gentler, and a whole lot more equitable. Only a few like busy-whiskers Fidel Castro, the creator of Cuba's present fabulous prosperity, still haven't figured out that the road to hell is paved with good intentions. At Copenhagen earlier this year, Castro was still denouncing "the blind and savage laws of the market."

We can see the agenda for the rest of the 1990s and into the next century being shaped by the debate that is now being waged in the United States. As the Speaker of the House, Newt Gingrich, has put it:

> The experiment we have had with professional politicians and professional government has failed. We have discovered that you can't hire people to think about your government and society and then walk off and let them do it. ... [Y]ou have to be engaged, you have to be involved, you have to reassert civic responsibility.

The business community is not exempt from this responsibility. The distinguished Catholic theologian, Michael Novak, who visited New Zealand earlier this year made the point that, as custodians of civil society, business people have an obligation to set a high standard of moral behaviour. He identified seven corporate responsibilities of business. These are to satisfy customers with goods of real value; to make a reasonable return on investors' funds; to create new wealth; to create new jobs; to defeat envy through generating upward mobility; to promote invention, ingenuity and progress in the arts and sciences; and to diversify the interests in a democracy and prevent the tyranny of the majority.

But civic responsibility does not end with running an efficient economy. Just as governments cannot plan and manage the business sector, neither can they legislate for good character. They cannot create vital communities. Trying to solve material poverty through expanding government welfare all too often just makes the problem worse, by making it too easy for citizens to shirk their responsibilities to family and neighbours, and by stifling initiative and fostering dependence. It's not sensible for the middle classes to pay taxes with one hand and get them back as benefits with the other. Government cannot build the strong independent associations - the churches, the sporting clubs, the civic groups - so essential to a robust liberal democracy. Government is not the enemy, but we have asked too much of it. Expecting governments to do these things is part of the disease, not part of the cure.

We understood many of these lessons rather better thirty years or more ago than we have in the intervening years. Our civic networks were in better shape, and we were a more caring society. When we delegated our civic responsibilities to politicians and bureaucrats, things came unstuck - as the superannuitant I quoted earlier so clearly understood. The *National Business Review* recently noted in an editorial that:

> New Zealand was not a happy place during the Kirk, Rowling and Muldoon years. It lived by its wits on an economic tightrope in the hope, like Dickens' Mr Macawber, that something might turn up. In fact, nothing did turn up except more debt.

It would be a cruel turn of fate, and a rotten legacy for our kids, if the electorate were to heed the siren calls of some political parties for a return to the 'good old days' that never were, and to the politics and policies of that period. All sections of the community have a responsibility to understand why we had to change and why we must sustain that change or risk losing much of what we have gained. If that happens, then, some time in the future, we will have to go through it all again.

SPECTRUM CLUB

THE BUSINESS ROUNDTABLE IN 1995

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ROTORUA
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THE BUSINESS ROUNDTABLE IN 1995

Thank you for inviting me to address you today and to talk about the New Zealand Business Roundtable. I have been a member of the Roundtable for a little over two years, dating from the time when the Forestry Corporation had its head office here in Rotorua.

I thought I would start by giving you some basic facts about the organisation and how it operates. Then I will talk briefly about our aims and the policies we have advocated. Over the years we have had both supporters and critics of our views and I will say a little about both. Finally, I will make a few remarks about how we see New Zealand's economic situation today and our aspirations for the future.

The Roundtable is primarily an organisation of chief executives of around 60 of New Zealand's largest businesses. In this it is similar to a number of others around the world. One of the first was the United States Business Roundtable which was established in 1972 and consists of the chief executives of about 200 of the top Fortune 500 companies in the United States. There is a European Business Roundtable, and closer to home we have the Business Council of Australia which represents some 80 of Australia's major companies.

Why an organisation of chief executives? Basically the answer is that if busy heads of large companies are to take a personal interest in public affairs, the only practical vehicle for them to do so is an organisation like the Roundtable. Generally they don't have the time to contribute effectively to other business organisations. Personally I think it is a very positive development that those leading large businesses in New Zealand have come together to think about overall national issues. This rarely happened in the past. More typically, businesses and business organisations promoted their own interests and those of their sectors, often at the expense of the general public interest.

The New Zealand Business Roundtable began as a loose association of business leaders in the early 1980s, but did not have any formal structure or office until 1986. As that date indicates, it was not an early contributor to the thinking behind the 1984 economic reforms, although some of its founding members had come to the conclusion that New Zealand had no option but to change course. Sir Ronald Trotter became the chairman of the organisation in 1985 and Douglas Myers has been its chairman since 1990.

Membership of the Roundtable is by invitation, although chief executives sometimes indicate an interest in joining. Last year we also created a category of associate member to enable the involvement of people of standing in the business community with a special interest in public affairs but who are not currently chief executives. There is a practical limit on numbers, so that members can sit "around a table" for a manageable discussion, as the name suggests. Members represent firms right across the economy - meat processing, horticulture, forestry, manufacturing, banking, transport, communications, information technology and so forth - so the organisation has to take an economy-wide view.

We meet five times a year for half-day meetings. Members play a role somewhat similar to directors of a company. They determine the general policy of the organisation, establish its work priorities, contribute information and ideas and monitor the work of the executive office. The chairman is the main public spokesperson for the organisation.

The office of the organisation is in Wellington and has four staff, including the executive director. Its operations are funded by member subscriptions. The main costs of the office are personnel and commissioned research. Its role is to handle the day-today administration of the organisation, undertake and oversee its research programme and represent its views to policy makers and other audiences.

The aims of the Roundtable were set out in a statement of purpose which was drawn up in 1986 and has not been amended. It states that the organisation "is committed to contributing to the overall development of New Zealand and to promoting the interests of all New Zealanders concerned with achieving a more prosperous economy and fair society." It endorses the concept of an open, competitive market economy and a medium-term policy orientation.

The statement sees an important role for the government in providing a sound framework of laws and a stable and predictable environment for private decision making. It also affirms a government responsibility to pursue social equity objectives in a well-considered and cost effective way.

The statement also talks about the Roundtable's style and method of operation. It says its aim "is to make a pro-active, professional and well researched contribution to policy formation, rather than to adopt a traditional lobbying role." It is concerned to be open in its analysis and advocacy, but does not seek publicity. Finally the Roundtable seeks to work with all governments in pursuit of the national interest but is concerned to be, and be seen to be, strictly a-political.

In the nearly ten years since the Roundtable was formally established, it has put out several dozen studies and reports on a wide range of economic and social issues. Our policy is to seek out the best expertise we can find to help undertake the analysis and shape our approach to specific topics. Our advisers have included consultants from many parts of the world and academics from leading universities such as Harvard, Stanford, Chicago, Pennsylvania, MIT and UCLA in the United States and others in Australia, Canada and the United Kingdom. If we have not got our thinking straight on any particular topic, it has not been for want of trying.

We have been prepared to go where the analysis leads us on policy issues even if the conclusions are controversial. Very often new ideas - or at least ideas that are new to New Zealand - are initially regarded as 'extreme' or 'politically impossible' but are accepted and become the conventional wisdom over time. How many people today want to turn the clock back on voluntary unionism, the removal of restrictions on shop trading hours, telecommunications and taxi industry deregulation, the abolition of tax concessions on superannuation, port reform, the Reserve Bank Act and a host of other measures which were highly contentious at the time?

It's no secret that the Business Roundtable has been a strong supporter of the thrust of the economic policy changes that have been made in New Zealand. That is not to say we agreed with all of the details, still less with all of the political management of the process. We were critical, for example, of the Labour government's failure to free up the labour market and to curb government spending. However, we firmly believe the reforms saved the country from certain economic ruin and have created the best outlook for a generation.

Most of what has happened in New Zealand is orthodox economics and commonplace around the world. It's hard to think of a country in the last ten years that has not been trying to curb inflation, rein in its public sector, reduce high tax rates, deregulate markets and privatise state-owned businesses. However, such policies were new and controversial in the New Zealand context and all those supporting them attracted their share of controversy.

One common criticism of the Business Roundtable has been that it has promoted policies which have been in the self-interest of its members. I can understand some people making that assumption. Many business and other lobby groups in the past did just that. Indeed when I joined the Roundtable I half-expected to hear elements of self-interest coming through in discussions. I have to tell you that has not been my experience.

My belief after two years' involvement is that most members belong in the first place because, as business leaders, they feel a responsibility to make a contribution to wider national affairs. As one of them said in response to a journalist's question:

> I belong to the Roundtable because I believe it is the most thoughtful and objective public policy organisation in New Zealand. I gain from membership by the hope that, as a result of its work, New Zealand will be a better place for my children and all New Zealanders.

To be sure, a strong, prosperous New Zealand economy will be good for businesses, large and small, in the long run. The Roundtable has never promoted the special interests of big business. Indeed, the changes in the economy in the last ten years have often been the most traumatic for large businesses that grew up in the old environment. As the member I quoted a moment ago said:

> In practice, policies advocated by the Roundtable, such as elimination of regulation and protection, have cost my businesses very heavily.

Moreover, even if they were only focused on their firms' own interests, members would have to be mindful of the interests of most members of the community. Business Roundtable firms account for about 10 percent of all goods and services produced in New Zealand, they employ around 200,000 members of the workforce, they handle the savings of hundreds of thousands of New Zealanders, and in a competitive market place their first concern must be for the even larger number of New Zealand consumers. In today's economy it's hard to believe that self-interest which was not consistent with the wider community interest would be a profitable long-run strategy for any of them.

In the final analysis, there is no short cut to determining whether people who claim to be arguing in the public interest are genuine in what they say. You have to consider the merits of the arguments. A sceptical attitude is fine, but not mindless cynicism. I believe that the Roundtable has argued with integrity in the overall national interest and that its arguments have stood up to scrutiny.

People often talk about the influence of the Roundtable, and refer to it as a rich and powerful organisation. I hope it has had some influence because I believe it has put forward sound arguments, but it's impossible to attribute influence. Many others have promoted similar views in the last ten years.

Certainly I don't think any influence it may have had has been due to wealth or power. Most of its members are professional managers. While they are well paid most of them are not among the seriously rich, and their pay reflects their responsibilities and performance. In today's competitive world they are often not at the top of the corporate ladder for long. Of the chief executives who were members of the Roundtable in 1986, only two, Douglas Myers and Bob Matthew, are there today.

Similarly the organisation is hardly wealthy. The Roundtable's budget is around $2 million a year, about the same as that of the largest chambers of commerce and well below those of organisations like Federated Farmers and the two teacher unions whose budgets are around the $5-6 million range.

I can't think of other sources of power either. We can hardly go on strike or march in the streets. We spend very little time with politicians as we are all busy running our businesses. The organisation hasn't had a meeting with the prime minister this year.

As for commercial power, that's almost non-existent in an open, competitive economy which favours consumers not producers, as some previously large firms discovered. Some of you may have heard the story about how to start a small business: buy a large business and wait!

Finally, I want to deal briefly with some of the criticisms of the kind of policies we have advocated.

One criticism is that the policies recent governments have adopted "put profits before people." Being "on the side of the people" has been the claim of populist politicians down the years - Sir Robert Muldoon was one in a long line. However, the claim is mere rhetoric. Of course the economy is about people. Economics is not an end in itself but a means of achieving social objectives. The issue is which economic policies lead to growth in living standards and jobs - goals most people share - and which are a recipe for disaster. Most of the pain of recent years was the legacy of previous disastrous policies, not the consequences of the reforms.

Nor have recent policies been in any sense 'right-wing.' The common feature of the politics of both the far right and far left has been the use of the power of the state to regulate people's lives. Current trends are a shift in the opposite direction. As David Henderson, who headed the economics division of the OECD secretariat for much of the 1980s, recently put it in a lecture in Australia:

> ... [recent] economic reform is often thought of as embodying, in political and ideological terms, a move to the right. In my view, this is an incorrect reading of events: conservatism is not the hero of this particular drama, nor even a central character in it. ... The true hero of this story... is *economic liberalism.* Recent events have involved a shift, not from left to right, but in the balance between liberalism and interventionism within national economies and the international system. ... [L]iberalism ... is concerned with setting limits to the powers and functions of government, so as to give full scope to individuals, families and enterprises ... .

Henderson points out that OECD governments *without exception* have been promoting the policies he describes as economic liberalism. In many cases they have been initiated by governments of the left - Australia, New Zealand, France, Greece, Spain, Sweden and the United States at different stages have been cases in point. The policies of the fast-growing Asian economies have been broadly similar.

Henderson also deals with the criticism that there has been a tendency for some time for the distribution of income to become more unequal in a number of OECD countries. However, he argues that it does not follow that this trend can be attributed to specific measures of liberalisation over the last 15 years, nor that liberalisation favours the interests of the rich rather than those of the poor. Henderson asks how the poor in Australia - or, he could have added, New Zealand - would have benefited, rather than the rich, if exchange controls had been retained, if restrictions on foreign investment had been strengthened, if interest rate controls had been kept in place, if high rates of protection had been maintained on footwear and clothing and if airlines and telecommunications had not been deregulated.

Recent research in Australia suggests that the drop in the earnings of low income groups has reversed in the 1990s, and the same may be happening in New Zealand with dramatically falling unemployment and current projections for growth in real wages. Certainly, as Henderson says, there is no iron law which says that growing inequality is a necessary feature of an economy which is more open, less regulated and less heavily taxed than are the OECD systems of today. The experience of the successful Asian economies which have combined fast growth with a remarkably even distribution of income bears out that observation.

For much of the 1980s and early 1990s, it was possible to be a Doubting Thomas or even a Cassandra about New Zealand's reforms. Now such a position is no longer credible. It is confined largely to a few academics and others who have never accepted that previous policies were running the economy into the ground.

One overseas commentator recently described New Zealand as "the nearest thing to an economic miracle I have seen." The figures clearly bear this out. The economy has grown by 15 percent in the last three years, the best performance among OECD countries. Around 150,000 new jobs have been created since the Employment Contracts Act was introduced in 1991. The speed of the reduction in unemployment continues to confound the forecasters, and only a handful of OECD countries now have a lower unemployment rate than New Zealand. Inflation has averaged 1.6 percent a year over the last four years. The government's accounts are in surplus, public debt is trending down, the balance of payments deficit is moderate and overseas debt ratios are declining. If these are the results of the dastardly policies the Business Roundtable has been said to be associated with, we are happy to take our share of the responsibility for the results.

As an organisation, we have not been concerned to seek popularity; that is almost ruled out by definition if you are challenging established views or vested interests. Rather, we have sought to gain respect for the quality of our work. Sometimes that has been forthcoming; as Bob Jones once put it:

> Although I sometimes disagree with the Business Roundtable's positions, I firmly believe that organisation has done more for the qualitative elevation of public policy debate than any in our history.

However, we don't regard ourselves as having a monopoly on wisdom; if anyone produces better research or logic we are happy to be shot down.

It's pleasing that most other business organisations now share the general perspectives which the Roundtable has put forward. However, any organisation that dares to break new ground will no doubt continue to cop flak. It would be nice if others were to make more of the running on policy reforms which would build on what has been achieved and increase New Zealand's economic security. Particularly in an MMP environment, there will be a need for a more broad-based consensus to achieve change, and in many ways that is no bad thing.

New Zealand will have to continue to work hard if it wants to regain the place it held in the top rankings for living standards up to the 1950s. The annual World Competitiveness Report is about to appear. Last year's report put us in third position for the quality of government policies, first for inflation and ninth overall. However, we got low marks for government debt, government expenditure, education, internationalisation and attitudes to foreign investment. This year's report may well see us move up the rankings a little further, but we will still have a lot of ground to make up.

Those who are still struggling in the community will not be helped if New Zealand decides to call a halt on economic reforms. Many people still do not see a dynamic, changing economy as the norm. Instead they think of change as something we have to go through - a painful remedy - after which good economic health is assured. This manifests itself in the desire for 'no more change.' The reality, however, is that change is a friend, not an enemy, of economic security. We discovered the cost of resistance to change over the many years that we tried to cocoon ourselves from the rest of the world. In the end, changes are forced on any economy and are more traumatic if a backlog of adjustment builds up. The best, indeed the only, form of security for New Zealand in the future will be to become a competitive, flexible, continuously adjusting economy which can take in its stride the worst the world throws at us and capitalise on all the opportunities it presents.

If we wish to keep advancing in terms of living standards, better jobs and security for the most vulnerable in our community, then organisations and individuals like yourselves will have to take an interest in these issues and make your views known to our political representatives. Ultimately it is the extent of community understanding of what constitutes good economic and social policy that determines the choices countries make. For its part, I am sure the Business Roundtable will continue to present a vision of how New Zealand could do better and put forward ideas that are bound to provoke debate. I hope what I have been able to tell you today will help you understand where we are coming from and that you will consider our ideas on their merits.

IIR CONFERENCE ON PUBLIC AFFAIRS AND LOBBYING

PUBLIC POLICY MAKING UNDER MMP

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NEW ZEALAND BUSINESS ROUNDTABLE

WELLINGTON
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PUBLIC POLICY MAKING UNDER MMP

A key issue for the investment community, and hence for the prospects for continuing growth in jobs and living standards in New Zealand, is the implications of the move to an MMP political environment.

There is a high level of agreement in the investment community that the only major risk now facing New Zealand is political risk. There is strong backing for the economic framework that has been put in place - indeed it attracts the admiration and envy of many outsiders. The vigorous expansion of the last two years is showing no signs of faltering. The outstanding question is whether the political consensus behind the economic reforms will be maintained.

On this issue, divergent assessments are still being made. Last year, for example, Moody's Investor Services took the view that the risk of a major deviation from present policies was unlikely, especially now that the restructuring was finally producing tangible results. Political realignments under MMP, Moody's said, would continue to reflect underlying support for the overall reform process.

On the other hand, only last month the investment banking firm Barclays de Zoete Wedd expressed a somewhat different view:

> The political risk does warrant some degree of caution. In recent months financial markets appear to have factored into current bond prices a premium for the change to the MMP voting system and the rise in popular support for the Alliance.

BZW stated: "We are taking a defensive stance on New Zealand. ... We are not looking to increase our exposure to the New Zealand sharemarket."

There is little doubt that New Zealand is paying an economic penalty for political uncertainty. Most obviously, it is adding a risk premium to the cost of capital to all borrowers, including those taking out home mortages. However, the point to be stressed is that the underlying cause of this risk premium is not primarily the change to MMP but the possibility of changes to the current policy framework. If all parties likely to end up in government or a governing coalition were committed to sound policies, investors would have little to worry about. It follows that all political parties bear a responsibility here and now for the economic consequences of their actions.

How likely is it that MMP will see a reversal of recent policies? In my opinion the risks can be exaggerated. Our organisation never saw the MMP debate as being primarily about economic management. As I said in a speech on the topic at the time:

> [T]he prime issue in the electoral reform debate is not, in my view, the economic policy directions that New Zealand is likely to take. Changes in economic thinking and practical experience are much more powerful factors than voting systems in determining economic policies. Current directions in New Zealand are in line with worldwide trends and are unlikely to change. ... However, calculations about economic policy should not drive the debate on electoral reform. While I believe there would be a deterioration in the quality of economic policy under MMP, the prime case ... against it ... is that it would be a less fair, less accountable and less democratic system.

Other assessments at the time concluded that, as far as economic performance was concerned, electoral arrangements did not appear to make a great deal of difference. Dr Alan Bollard, then director of the New Zealand Institute of Economic Research, identified a tendency towards a lack of discipline in fiscal policy as being the main weakness associated with proportional systems. That weakness may have been remedied, at least to some extent, by the Fiscal Responsibility Act.

When you think about it, electoral systems have rarely been a factor of overriding importance in the economic history of most countries. Much more important have been their choices about the role and scope of government.

The historical tension has been between two views of government. One view, associated with the political idealists and the visionary socialists, was that of the powerful and benevolent state. The other, associated with the thinkers of the Enlightenment and the American Founding Fathers, was highly sceptical about the capability and willingness of politicians to further the interests of the ordinary citizen. In this view, governments were considered a necessary evil, from which citizens needed protection. The essence of the United States constitution is a concept of limited government, ascribing to the political domain those functions and only those functions that must be undertaken by collective authority.

Thus, reviewing constitutional issues and alternatives of governance, Professor James Buchanan, who won a Nobel prize in economics for work on public choice, concluded a recent paper with the following observations:

> I have not addressed such issues as republican versus parliamentary forms of government; proportional representation versus two-party structures; effective federalism versus political centralisation. But my neglect of these issues has been quite deliberate. All such organisational - procedural matters fade into insignificance by comparison with the constitutional challenge of placing constraints on the authority of government over the operation of the economy. ... To the extent that constitutional constraints do effectively limit governments in their regulatory, financial and taxing powers, the particular form for governance itself assumes secondary rank.

On this view, initiatives such as the Reserve Bank Act, the Fiscal Responsibility Act and the constraints arising from New Zealand's openness to international trade and world capital markets may be of more significance for policy choices than the changed electoral arrangements. This thesis is reinforced by the fact that the so-called "romance of politics" appears to be on the wane worldwide. Governments elected under many different systems are following broadly similar market-oriented policies.

There are, therefore, a number of grounds for thinking that the move to MMP will not fundamentally change the factors that have shaped public policy in New Zealand. Indeed the *Herald* in its editorial columns and David McLoughlin in *North and South,* among others, have argued that, contrary to the beliefs of some of its proponents, MMP will serve to lock in the reforms. That view has become increasingly plausible in the period since the referendum. A more serious concern is that MMP could lead to paralysis, that New Zealand will find it more difficult to go forward and make the continuing adjustments that will be necessary in response to global economic change. Whether or not that happens, however, will ultimately be determined by the ideas that prevail in future public policy debates. In a famous passage, the economist John Maynard Keynes recognised the power of ideas in determining political choices. "Indeed," as he put it, "the world is ruled by little else."

I have long been a believer in the view that good ideas eventually replace bad ones in an open, competitive contest, and more particularly that they can defeat the lobbying of pressure groups that represent narrow interests rather than those of the community as a whole. Time and again in the last decade we have seen the lobbying of groups such as protected manufacturers, trade unions and coastal shipping operators yield to arguments based on the wider public interest.

As an organisation representing businesses right across the economy, the Business Roundtable is forced to take an economy-wide view, and indeed it is committed to do so by its charter. As New Zealanders, the goal of its members has been a better New Zealand, and as business people they have recognised that only a healthy, prosperous economy will be good for business in the long run. In this our approach has been very similar to other broadly-based organisations such as our counterpart in Australia, the Business Council. On the occasion of its tenth anniversary in 1993, various leaders of the Business Council made remarks which reflect closely our own perspectives and experience:

> The Business Council's formation in 1983 recognised that the leaders of our major companies needed to take a more active role in the broader political and economic affairs of Australia. ...
>
> Business Council companies collectively represent an enormous part of trade, employment, investment, value-added and overall influence in the economy. ...
>
> We do not see ourselves as a lobby group if this means pursuit of narrow interests. We see ourselves as developing objective long-term views in the pursuit of broad national interest. ...
>
> It is important that we do not fall for the "snake oil" analysis that asserts there is a fundamental difference of view and aspiration between big and small business - the health of both is critical to the nation. ...
>
> Business, like other social institutions, can survive only with the legitimacy accorded to it by its community, within rules determined by its government and on a basis won and defended against a variety of pressures. ...
>
> [A] powerful lesson from the first ten years of the Business Council of Australia is that good ideas will prevail if champions of them are well organised, patient and determined. ...
>
> [T] he Council has consistently eschewed opportunities to negotiate for short term advantage. Instead, it has sought to focus on medium term policy improvement, believing that in the longer term this will maximise its community standing and its influence with both major political parties.

Reform has not occurred as rapidly in Australia as New Zealand, but there is little doubt that ideas such as labour market deregulation, tax mix changes, privatisation and other microeconomic reforms will ultimately be adopted in that country also.

Many have not yet come to terms with the extraordinary reversal of conventional expectations in the producing sectors of the economy. In the old New Zealand, lobbying for special privileges by business interests, just like lobbying by professional associations, trade unions, farmers and others, was regarded as part of the natural scheme of things. Today attempts like those of the coastal shipping industry to retain its protected status are regarded as bad form. Last month the chief executive of Federated Farmers listed his organisation's pork barrel list of favours: "Nothing-zero-zip - other than fairness and consistency in government policy." Contrary to the views of people like Colin James that old-style lobbying is on the way back under MMP, I do not believe that things are likely to change.

There continue to be interesting signs of adjustment to the new realities. The Pharmacy Guild, which has held out for years against the introduction of pharmacies into supermarkets, appears to be recognising the inevitability of supermarket competition. Some of those who were formerly promoting concessional tax treatment for offshore banking have now seen that their interests would be equally well served by a lowering of general income tax rates to 10 or 15 percent, a goal that should be readily achievable within the next 10 years. Last year the New Zealand Stock Exchange decided to resist ill-conceived proposals for takeover regulation despite an expectation that populist pressures might well prevail, and found that sound arguments carried the day.

In the past, businesses often yielded to pressure groups such as extreme environmentalists despite the lack of a scientific basis for their arguments. Today they are more likely to stand up to them. Businesses even financed organisations that were hostile to their interests. Today it is noticeable that the mainstream churches, which have been consistently hostile to the business sector and the reforms which it has supported, are losing business sector support and finding themselves increasingly isolated on economic and social issues. The common theme in these examples is a greater recognition of the force of logic and ideas and a greater willingness to do what is right rather than what is currently popular or expedient.

It is often said that under MMP there will need to be more consultation and participation in policy making. I agree with that view and welcome it. Just as free and open markets usually provide consumers with the best quality products, so a free and open contest for ideas will yield up the best answers for policy makers. Open processes of inquiry are often an effective tool for disarming powerful interests. In addition, they may finally give the lie to theories that policies have been driven by conspiracies, ideologies or other sinister influences.

We have already seen such processes at work in the last couple of years.

One model example is the Reserve Bank's review of banking supervision. The Bank put out no fewer than three papers on the subject, and invited comments on each occasion. It went to considerable lengths to talk the issues through with interested parties. The proposals were refined and improved at each stage. The end result is a high quality package that has attracted a broad measure of support.

Another interesting example was the Todd committee on the funding of tertiary education. The starting point of the four members of the committee drawn from tertiary institution administration was that there should be no increase in fees. The starting point of the two student representatives was that fees should be scrapped. In the face of the logic and evidence in favour of fees, the group of four ended up supporting a 25 percent increase (from the present level of around 20 percent to a level of around 25 percent of average course costs) and the student representatives moved to an acceptance of the status quo. This suggests, for example, that the Alliance's support for zero fees reflects an appeal to special interests rather than overall community interests and is not a position which would be upheld by an open, impartial inquiry.

Looking ahead, it is also possible to conjecture with some confidence about the outcome of an open review of the statutory privileges still enjoyed by the main producer boards. Our organisation has frequently called for such an inquiry, to no avail. Every independent authority that has looked at the regulatory issues in recent years has found a need for significant change. The list is now a long one: it includes the Economic Development Commission, the Porter Report, the ACIL study for the Business Roundtable, the Treasury, the Ministry of Agriculture and Fisheries, the Scobie report on the meat and wool industries, the OECD and even the inadequate Auckland University report on the kiwifruit industry.

There are many politicians in all political parties who understand the need for comprehensive reform of agricultural maketing regulation. To date the boards' privileges have been upheld by the present minister of agriculture, but that is not a particularly secure or permanent basis for their legitimacy. The argument that they are supported by a majority of industry participants is also a specious basis for public policy, and one that has been rightly rejected in contexts ranging from trade union reform to coastal shipping. Sooner or later we can be confident that overall national interests will prevail, and an open public inquiry or the advent of MMP may well hasten the process.

It is nevertheless the case that in some crucial areas of community concern, public debate is still not well informed. In areas like education, health and social welfare it tends to be dominated by ideological positions which seem impervious to facts and objective discussion. Unthinking attachment to heavy central government involvement remains strong. Whereas in the commercial sphere New Zealand has moved a long way from its state-dominated past, in the social areas we are still clinging to past policies despite the widespread acknowledgement of their failures. However, it is easy to forget that almost all the major reforms of the last ten years - the dismantling of import licensing, port reform, the removal of restrictions on shop trading, taxi deregulation, GST and so forth - were fiercely contested at the time but are now broadly accepted. Sound arguments may eventually attract the same consensus in the social areas as well.

If it is the case that MMP will see more consultation and open debate on public policies, it follows that organisations that put emphasis on research and quality analysis will be well placed in the new environment. David McLoughlin has expressed the view that "In the new politics of ideas, the Roundtable has the advantage. Its forte is meticulous research, not invective." But the point is that any organisation can aim for high quality research and analysis. The market is highly contestable and contests for quality could well drive up the standard of decision making.

By contrast, groups that rely on shonky arguments or emotional appeals may well find themselves exposed. After the green scares of the 1980s, America's environmental groups have been losing members fast. The membership of Greenpeace, for example, has dropped 40 percent since 1990. Greenpeace New Zealand clearly felt threatened when we brought a leading atmospheric scientist to New Zealand recently to debate the scientific evidence on global warming. The teachers unions are similarly exposed now that their extravagant predictions about the effects of salary bulk funding have proved groundless.

Sir Roger Douglas has said that an organisation interested in public policy should devote about 80 percent of its resources to research and publications and the balance to communicating its ideas, and I agree with him. Good ideas have a way of being taken up eventually in the policy making process; they do not require arm-twisting, media campaigns or demonstrations in front of parliament to be accepted.

At the same time, it is important for any organisation with broad interests to maintain open lines of communication with all political parties. In the past year we have had meetings with the prime minister (twice), the leader of the opposition, and the leaders of Future New Zealand, ROC, ACT New Zealand and the Christian Heritage Party in order to brief them on our perspectives and hear their views. The leader of the Alliance was due to attend our meeting last November but resigned the previous day. We have responded to invitations by New Zealand First and the Alliance to comment on their policies. Any major organisation must be able to work constructively with all political parties. The action by the Council of Trade Unions in 1993 to cling to political affiliations and to campaign "to make sure the government is defeated" was extraordinary and did no service to its members. Partisan alignments will be even more out of place in an MMP environment.

Nothing that I have said in this paper should be taken to suggest any change in the basic analysis of the disadvantages of MMP that I mentioned earlier. I continue to believe it is a less than satisfactory democratic system and would not be surprised to see it thrown out in the next ten years. Moreover, the political risks involved in the transition are significant. Those who have to make the new system function effectively will be on a steep learning curve. Voters are unaccustomed to the political instability that could result from a parliament in which minor parties have a lot of power. Dissident politicians in the major parties could add to the problem. The public service has little experience of the role it might be expected to perform when caretaker governments are in office for long periods. The need for issues to be resolved by inter-party negotiation may mean that 'urgent' matters drive 'important' longer-term issues off the political agenda. Deal-making is likely to be a threat to the integrity of policy, particularly if proper research is not done beforehand.

All this adds up to a degree of risk which calls for cool management. Political uncertainty can be devastating even for a tolerably well-run economy, as Mexico's recent experience demonstrates.

Nevertheless, MMP is not an end-of-the-world scenario, and we all have to contribute to making it work. It is certainly not, in itself, a threat to the economic directions New Zealand has been following. My argument has been that the advent of MMP will not change the fundamentals of the public policy debate, and that there could even be an upside to it if it breaks down the linkages of special interests with established political parties and makes for a more open contest for ideas. As the poet John Milton once wrote: "Let [truth] and falsehood grapple; who ever knew Truth put to the worse in a free and open encounter?"

TASMAN INSTITUTE

LOOKING BACK TOGETHER

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

MELBOURNE
22 NOVEMBER 1994

LOOKING BACK TOGETHER

I am deeply honoured by this award of the inaugural Tasman Medal for contributions to economic reform. I hope I can live up to it in my future work. It's a double honour to enjoy the company here tonight of so many of those who, in the words of Austin Holmes, have fought the good fight for ideas in the lands of the kangaroo and the kiwi.

I've learnt from long experience to be cautious about taking messages to other countries. The kind of pitfalls you can encounter are similar to those of an aspirin company that decided to enter the Singaporean market. Its marketing department prepared a simple advertisement with three panels. In the first was a picture of a person with his head in his hands and agony on his face, clearly suffering from a terrible headache. The second panel showed the sufferer with a glass in his hand swallowing the new product. In the third, our victim appeared smiling and free of pain.

The product was duly launched in a blaze of publicity. The only problem which the advertisers had overlooked was that Chinese-speaking people read from right to left.

I owe that story to an Australian, just as I owe so much to associations with Australians in economics and politics over the last fifteen or twenty years.

I recall a discussion in 1979 with Graham Scott who went on to become Secretary of the Treasury in New Zealand. At the time we were both involved in setting up a division in the Treasury to focus on policy research and the development of sounder long-term strategies for New Zealand. We were wondering what capacity we might have to change for the better New Zealand's dismal record of decades of economic mismanagement, which was reaching its culmination in the madness that was Muldoonism. "The only power we have," Graham Scott observed, "is the power of the typewriter."

John Hyde has recalled a similar discussion in 1980 among some of the market liberals in the Federal parliament. He said at the time that if they could put back the date when Australia finally went down the tube by half a generation, they would not have lived in vain. Some of us in New Zealand felt much the same way .

The trouble was that we had only some rather basic notions of what needed to be put on the typewriter. The general standard of official economics in New Zealand in the 1970s was appalling and that of academic economics, Canterbury University apart, was even worse. For much of the decade the Treasury remained a positive advocate of import controls. The only prominent senior official with anything like a modern view of economics was Roderick Deane at the Reserve Bank. Ask John Stone for his views on New Zealand economic thinking at that time.

In recent years various political scientists and journalists have set off on a search for the intellectual 'influences' behind the changes in New Zealand's economic and social directions. A bewildering range of exotic sources have been proposed. A generation of students is now reading these fables in university libraries.

I can only speak for myself - though I suspect the same is true for others - but I remain oblivious to this day of many of the presumed sources of influence. I say this with no pride, as I am sure that I am the poorer for it, but I have read nothing of Ayn Rand, Robert Nozick or Murray Rothbard. I have read only a few of Hayek's works, even though I regard him as this century's foremost economist and social philosopher.

Most of us involved with economic policy were probably broadly familiar with Friedman's writings, but we were never sympathetic to monetarist approaches to monetary policy and advised against them. Ironically, the only monetarist rule applied in New Zealand was a decision by Sir Robert Muldoon to set a target for private sector credit. Nor were we impressed by the supply-side doctrines which were fashionable in the early Reagan years; a visit by Stephen Entin, a high-ranking US Treasury official, left us distinctly underwhelmed.

The reality was very different and much more mundane. The search for influence is pretty futile. I think we learned most from our own practical experience with the crazy experiments that had been inflicted on the New Zealand economy. New Zealand had strayed so far from the economic mainstream that the way back was fairly self-evident. It was a matter of undoing much of what had led to the economic convulsions of the early 1980s.

In this we were greatly helped by sources much closer at hand than the universities of Chicago and Vienna. The economic papers published by the Australian Treasury in the 1970s and early 1980s were a rich source of good policy analysis. In the space of a few years we absorbed the enormous contribution which the Industries Assistance Commission had made on protection and regulation. Books like *Australia at the Crossroads* dealt with the same problems we were struggling with. We found Michael Porter's work at Monash on state-owned enterprises much more useful than anything coming out of the United Kingdom at the time. The Campbell inquiry greatly helped our thinking on financial sector reforms. Peter Jonson, then of the Reserve Bank of Australia, gave us very useful insights on the case for a floating exchange rate. We established connections which remain valuable to this day with academics such as Wolfgang Kasper, Richard Blandy and Ted Sieper. Think tanks like those of Greg Lindsay and John Hyde provided a fresh stream of ideas. These and other debts to Australia are enormous, but they supplemented rather than substituted for home-grown experience.

As we moved along the learning curve, the body of economics that developed bore little resemblance to the neoclassical label that is still sometimes placed upon it. Among other things it incorporated insights from principal-agent theory, transactions cost analysis, the economics of organisation, Austrian thinking on entrepreneurship and dynamic market processes, and public choice. The risks of government failure were weighed alongside those of market failure in analysing policy options; we learned that the fact that a fish can't fly doesn't mean that a rhinoceros can do any better. In recent years, more and more attention has been paid to the institutional framework for decision making, with initiatives like the Reserve Bank Act and the Fiscal Responsibility Act. All of this is, or should be, the stock-in-trade of any practising economist.

These same insights were being incorporated into international thinking in forms such as the OECD's studies on positive adjustment policies in the late 1970s and the IMF's work on stabilisation and liberalisation. International visitors who were very helpful in specific areas of policy included Michael Boskin, John Shoven, Charles Goodhart, Anne Krueger, Jan Tumlir, Greg Jarrell and Thomas Moore. The Thatcher and Reagan programmes were also part of the background, although the flaws in them were well recognised. And of course the same ideas were finding their way into New Zealand politics, through voices such as those of Derek Quigley, Roger Douglas and Ruth Richardson, the last two being the dominant political figures in the past decade of reforms.

I often think it is ironic that New Zealand finally caught the international tide and cast off its repressive, big-brother government legacy in 1984, the fateful year of George Orwell's great political novel. Since then we have gone through a very difficult transition, not just in economic terms but also in the way we think about ourselves as a society. This change is not unlike those still underway in Eastern Europe.

The first part of the transition involved what turned out to be seven difficult years. The task of transforming an inflation-prone, debt-ridden, hyper-regulated and inward-looking economy was always going to be formidable. It was compounded by policy errors, particularly the failure to free up the labour market and clamp down sufficiently on government spending, by the sharemarket crash and the international recession that followed, and by the Labour government's disintegration after 1988.

The turning point was reached in 1991 when the National government addressed the key policy weaknesses and the economy began its present recovery. We are now into what is likely to be a period of at least seven good years. This year has been the best year for the economy in a generation.

Along the way, we were fortified by several important influences and events.

The first was a hard core of politicians in the main political parties who maintained the vision and gradually won their colleagues around. They had to endure widespread opprobrium during the difficult years and they deserve the nation's gratitude.

Beyond the circle of the government's own economic advisers, the main sources of support were elements in the private sector. Farmers were among the earliest supporters and, outside the area of statutory marketing arrangements, have remained solid advocates of an open, competitive economy.

In the business sector, the Business Roundtable, which is the counterpart of your Business Council, backed the reform programme. It was set up in its current form in 1986 with broad representation and a commitment to an economy-wide and longer term view. It has been prepared to argue fearlessly for changes which were initially controversial but have now become widely accepted. Today most other New Zealand business organisations share our general perspectives. That the organisation maintained its integrity and avoided self-serving lobbying in the face of criticism and commercial pressures is due in no small measure to its two chairmen, Sir Ronald Trotter and Douglas Myers.

External events have also helped. Australia's decisions to free up capital markets and reduce tariffs made our task in those areas easier. The worldwide moves to deregulation, privatisation and lower taxes helped many to understand that we were not out of step with international trends. Easily the most significant event of the period, of course, was the fall of the Berlin Wall in 1989. In a historical sense, that year was the end of our century. It marked a decisive turning away from decades of collectivism towards economic and political liberalism, a shift in opinion which will influence our countries for many years to come.

Great as these changes have been, the changes in national attitudes have been even more striking. After years of decline, New Zealanders had come to think of themselves as losers. The popular belief was that our market was too small to allow competition, our workers were too lazy, and nobody else had a level playing field so why should we? The main form of entrepreneurial flair was approaching the government for assistance.

Today, as Paddy McGuinness recently wrote, New Zealand confidently faces the world in a way it has not done in living memory. Business people tell politicians they want sound economic fundamentals not handouts. Watersiders have been seen running on the job. 'She'll be right' has gone and been replaced by a recognition that we must aim to be world class and internationally competitive in everything we do.

Where to from here? In the year to June the economy grew by 6 percent and seems likely to continue at a strong clip. Employment is growing at an annual rate of over

4 percent, and business investment is up by around 20 percent. Company balance sheets are strong. The budget surplus is likely to come in at around 2-3 percent of GDP this financial year. There are no signs of wage or price inflation or balance of payments pressures which would bring the expansion to a halt. The unemployment rate is down to 7.8 percent and the forecasting agency that has been the most pessimistic in recent years has it falling to 6.4 percent by the end of next year. Such are the results of the dastardly policies which you call economic rationalism.

However, we have only just started on the long road back. Within my working life, the New Zealand dollar was worth much more than the Australian dollar and our per capita incomes were on a par with yours. Now they are only about three quarters of those in Australia.

V J Carroll noted recently in *The Australian Financial Review* that in the past three years the $A has fallen from $NZ1.40 to $NZ1.20 and said that parity might be reached before the All Blacks regain the Bledisloe Cup. As far as I am concerned, that is not a problem, and Vic Carroll may have overlooked an important relationship which has been carefully charted by one of my financial market colleagues. It seems that the worse New Zealand does at sport, the better the economy performs. Indeed this relationship survived its strongest test at the recent Bledisloe Cup fixture. An awesome responsibility rested on young Jeff Wilson's shoulders in the very last minute: save the game or save the economy. He did the decent thing and threw away the ball. This augurs well for the future.

With the benefits of the reform programme now clearly apparent, the mood in New Zealand, certainly in the business community, is that we must work hard to build on economic success. The task falls to both the private sector and the government. There is as much to be done in the next ten years as in the last ten. New Zealand has still not put behind it the vulnerability associated with a high debt level and a low credit rating. To people complaining about repeated requests to accept change, W Edwards Deming, the father of TQM, made the appropriate response: "You don't have to do it - survival is not compulsory." It makes no sense to sit on our hands when more could be done to consolidate and spread the benefits of change, particularly to those in the community who have not yet felt them. Governments have forced New Zealand businesses to match world class standards of performance, and rightly so. We now expect the same of them.

Fortunately, the intellectual climate has never been better for continuing in the directions that have been mapped out. As Antonio Martino, now Italy's Foreign Minister, said in a lecture in New Zealand a few years ago:

> Liberalism has faced the challenge of Marxism, Fascism, welfare statism, and Keynesianism, and it has won; except for a few desperate, hopeless fanatics, no one believes in central planning, nationalisation, wage and price controls or incomes policy, deficit spending, inflationary growth, protectionism, the superiority of public health care, and all the assorted paraphernalia of excuses for bigger government that were so overwhelmingly popular only a generation ago.

The challenge for New Zealand in the next ten years is to match our fast-growing Asian neighbours and to press on with policies which will get debt and taxes down, remove all import and export barriers, make labour markets more flexible, avoid welfare dependency, introduce choice and competition into sectors such as health and education and privatise remaining state-owned enterprises. This year we have made some further progress - for example, decisions just this month will mean that coastal shipping and postal services will at last be fully deregulated, and there are widespread calls to eliminate all tariffs by the year 2000 in the present tariff review - but we need more momentum.

In addition, just as in Eastern Europe there is a major task in New Zealand to change belief systems that have prevailed for many years. New Zealand was described by a European visitor early this century as a country which had adopted "socialism without doctrine," and that remark sums up much of our history. Elements in the universities, the church and the media in particular have still not come to terms with the immorality as well as the inefficiency and inequity of old New Zealand. As *The Spectator* put it recently in an editorial:

> ... the arguments for freer markets and wider privatisation, as well as the arguments against the European Community's social chapter and the minimum wage, are, at the most basic level, still moral arguments, just as they always have been. Capitalism is a moral economic system because it forces individuals to be responsible for themselves; because it rewards hard work; because it is meritocratic and not bureaucratic; because it creates the most jobs for the most people, thereby eliminating socialism's shocking waste of human time and society's resources.

I am an optimist for New Zealand. I think we have made some wrong moves, such as the change to our electoral laws, but mainly because it is likely to result in a somewhat less satisfactory democratic system not because it poses a serious threat to our economic directions. There is now a widespread belief that MMP will serve to lock in the reforms, and it may even facilitate further progress. Sound public policy arguments and practical experience are likely to be stronger influences on public and political choices than the details of the electoral system, just as they have been in other countries.

I hope for both our countries' sakes that sound ideas take a stronger hold in Australia as well. In recent years we have missed the impetus of good Australian ideas and initiatives. To us the economic debate in Australia at times almost seems to be couched in a foreign language. Some of it is positively Orwellian: we learn that national competition policy requires the shutting out of foreign airlines, for example. More than anything else recently, that decision was a sharp reminder to New Zealanders about how far we have come. Institutions such as wage fixing tribunals, government purchasing schemes and price surveillance authorities are now, mercifully, a distant memory for us. Even when I try to read the page from right to left it's sometimes hard to make sense of the picture.

Ten years ago we envied Australia for the Industries Assistance Commission, the Centre of Policy Studies, the Campbell report and the like. Today there is no sense in New Zealand of schadenfreude - the sense of satisfaction that some people apparently get from seeing their neighbour's Rolls Royce in the ditch. New Zealand's own inglorious past is too recent for that - as Ray Evans noted recently, the virtually unanimous opinion of informed New Zealand watchers in the late 1970s and early '80s, particularly in Australia, was that New Zealand was a basket case headed irrevocably downhill towards third world status.

However, there is a feeling on our side of the Tasman that Australia is under-performing relative to its great potential, and it would be far better all round if we were both strong competitors in the Asian growth stakes. There is a global flow of economic change which we must both keep up with, or ahead of, if we are not to fall behind. Lee Kuan Yew remarked this year that Australia and New Zealand had wasted twenty years before embarking on the reforms of the 1980s. A return to drift would at best see us even further down the income rankings in twenty years' time and at worst back on the rocks.

Let me finish on a hopeful note with two quotations, each with a similar message. The first is from Victor Hugo: "An invasion of armies can be resisted, but not an idea whose time has come." The second is from Robert Haupt, writing recently in *The*

Australian Financial Review: "When Australian political history is written, who sat in The Lodge doesn't count for much; whose ideas prevailed is what matters."

Given patience and application, sound ideas from bodies like the Tasman Institute are likely to have some influence. Our experience suggests that business organisations can also make a difference if they put their minds to it. I hope that in the next few years lots of Tasman Institute medals go to Australians for successful contributions to better public policies.

THE PAIN HAS TURNED TO GAIN

ARTICLE BY ROGER KERR FOR
THE INDEPENDENT
16 DECEMBER 1994

THE PAIN HAS TURNED TO GAIN

Economically speaking, it's been an *annus mirabilis*. As *The Asian Wall Street Journal* put it in an editorial earlier this month:

> It's been only a decade since New Zealand was the sloppiest, most terminal welfare state in Christendom. ... Some New Zealanders probably thought the long-run would never come. For their pain, they now have an economy outfitted for the best possible performance whatever squalls the global marketplace might throw in its path.

Earlier this year Jim Anderton said the government would be "lucky to see 1 percent growth." The reality is that economic growth is likely to average around 5 percent for each of the two years to March 1995. Ken Douglas complained about low company tax revenue and an "endless wage freeze." Business tax collections have soared and average earnings rose by 2.8 percent in the year to September compared with a CPI increase of 1.8 percent.

A year ago I wrote:

> Many economists have failed to appreciate that the Employment Contracts Act has radically altered the dynamics of the labour market. The forecasts of only slow falls in unemployment will turn out to be far too pessimistic.

The spectacular rate of job growth is the best news of all. If the next election is held at the end of 1996 and present policies are maintained, unemployment could well be below the 5 percent mark.

The quality of the present expansion is remarkable. The last year the economy grew by nearly 5 percent was 1984/85, which was followed by a year of less than 1 percent growth. The expansion was unsustainable: the fiscal deficit in 1984/85 was over 5 percent of GDP, the current account deficit was 8.3 percent of GDP and inflation was 13.3 percent. None of these factors threatens the present expansion.

For most of the last 5 years, the economy has had little help from the outside world. The current outlook is for strong international growth. The benefits of the Uruguay Round will also kick in from 1995.

Only the ideologically blinkered now deny the success of the economic reforms. By maintaining and strengthening them since the election, the government has kept business and investor confidence at a high level. The year will be remembered for the achievement of a significant budget surplus, the Fiscal Responsibility Act and, it is to be hoped, a strong decision on tariffs which points the way to full free trade.

Now that the gains are undeniable, the critics' complaint is that they are not being widely shared. This too is wrong: the ECA has rightly meant priority has been given to employing the unemployed at this stage, rather than to large pay increases for those in work. With 64,000 new jobs being created in the past year and wages rising where skills are becoming scarcer, the benefits of the reforms are clearly spreading. But more progress is needed; those in the community who have not yet felt the benefits will not be helped by policy inaction, and there is now more scope for them to help themselves.

Both the private sector and the government have important work to do. As a commentator said at a recent investment conference:

> All I've heard is what your country has done over the last 10 years. What I really want to know is what happens now.

The business sector must keep up the momentum of productivity gains. It must be prudent in its investment and borrowing decisions. It must reject soft options and support the Reserve Bank's task of leaning firmly against the wind to avoid another inflationary cycle. The focus must be on the underlying factors that determine competitiveness - the real exchange rate - not just the value of the currency.

The outstanding agenda for the government remains a very large one. Two examples will illustrate the point.

First, fiscal risks remain high. There is a cyclical component to the present upturn and we must not go into the next downturn with current debt levels. Government spending must be kept tight to free resources for private investment - which is now the key to productivity improvements and sustained growth - and prepare the way for tax reductions. The government still takes one third of national income in taxation; the average figure in Asia is nearer one fifth. And in the past year Hong Kong and Malaysia have both *reduced* tax rates, and Singapore is expected to follow.

Second, while New Zealand had the highest ranking among OECD countries in the 1994 World Competitiveness Report for the overall quality of government policies, it only ranked in seventeenth place - just above India - on the criterion of how well the education system meets the needs of a competitive economy. Both formal skills and 'soft' skills - such as attitudes to work - are lacking. An obvious next step would be to expand educational choice and competition by resourcing both government and non-government education providers on an equal basis according to enrolments, with adjustments for special needs.

Although some of the decisions that lie ahead will be difficult - in that they will challenge vested interests - the prospective gain to pain ratio is now much more favourable.

New Zealand could easily make as much progress in the next ten years as it has in the last decade. Our reforms are attracting international attention; Prime Minister Goh recommends New Zealand as a country for Singaporeans to invest in. Similar programmes are bringing success elsewhere: who would have thought 5 years ago that Argentina's inflation rate would be 4 percent today or that India might be Asia's next economic miracle? The lessons of prosperity are becoming increasingly clear. As the *Far Eastern Economic Review* put it last month, after all the necessary qualifications, the general prescription is that the private sector is to be preferred over the public; that countries that close themselves to trade doom themselves to poverty; that the family needs to be strengthened and maintained, not weakened by legislative intrusion; and that you do not help the poor by attempting to punish the rich.

New Zealand still has lessons to absorb and much catching up to do. However, after slipping well behind Australia we are now shaping up better than our old rival, which may well be heading for a hard landing next year. Within the next decade we could close the gap on Australia in terms of living standards and economic performance. Even more than winning the Bledisloe Cup, that is a goal that is surely worth striving for.

LIST OF NEW ZEALAND BUSINESS ROUNDTABLE

PUBLICATIONS

	PRICE (incl. GST)
NEW ZEALAND LABOUR MARKET REFORM April 1986	22.50
THE NEW ZEALAND PORTS INDUSTRY August 1986	11.25
INDIRECT TAXATION POLICY December 1986	11.25
SUBMISSION TO THE LABOUR SELECT COMMITTEE - THE LABOUR RELATIONS BILL March 1987	9.00
BETTER VALUE FOR PUBLIC MONEY - THE GOVERNMENT'S 1987 BUDGET AND MEDIUM TERM FISCAL POLICY May 1987	9.00
FREEDOM IN EMPLOYMENT - WHY NEW ZEALAND NEEDS A FLEXIBLE DECENTRALISED LABOUR MARKET June 1987	No Charge
REVIEW OF ACCIDENT COMPENSATION - A SUBMISSION TO THE LAW COMMISSION July 1987	33.75
CORPORATISATION OF HARBOUR BOARDS August 1987	11.25
TELECOMMUNICATIONS IN NEW ZEALAND - THE CASE FOR REFORM November 1987	33.75
PUBLIC OPINION SURVEY OF INDUSTRIAL RELATIONS ISSUES November 1987	11.25
TOWN AND COUNTRY PLANNING - TOWARD A FRAMEWORK FOR PUBLIC POLICY November 1987	33.75
REVIEW OF ACCIDENT COMPENSATION - SUPPLEMENTARY SUBMISSION TO THE LAW COMMISSION December 1987	5.60
COMMENT ON THE REVIEW OF THE TOWN AND COUNTRY PLANNING ACT 1977 BY A HEARN QC December 1987	5.60
THE REGULATION OF SHOP TRADING HOURS - SUBMISSION TO THE SHOP TRADING HOURS ADVISORY COMMITTEE March 1988	5.60

SUBMISSION TO THE COMMITTEE INQUIRING INTO "DEPENDENT" CONTRACTING March 1988		5.60
SUBMISSION TO THE LAW COMMISSION ON COMPANY LAW March 1988		22.50
LABOUR MARKETS AND EMPLOYMENT - NEW ZEALAND BUSINESS ROUNDTABLE STATEMENTS ON LABOUR RELATIONS April 1988		33.75
STATE OWNED ENTERPRISE POLICY - ISSUES IN OWNERSHIP AND REGULATION April 1988		33.75
REFORMING TERTIARY EDUCATION IN NEW ZEALAND June 1988		33.75
UNEMPLOYMENT INCOME SUPPORT IN NEW ZEALAND - OPTIONS FOR POLICY REFORM September 1988		22.50
REGULATING FOR OCCUPATIONAL SAFETY AND HEALTH September 1988		22.50
ANTITRUST IN NEW ZEALAND - THE CASE FOR REFORM September 1988		56.25
EMPLOYMENT EQUITY - ISSUES OF COMPETITION AND REGULATION November 1988		33.75
SHAREBROKING AND EQUITY MARKET REGULATION - A SUBMISSION TO THE MINISTERIAL COMMITTEE OF INQUIRY INTO THE SHAREMARKET December 1988		33.75
INDUSTRIAL RELATIONS ISSUES IN NEW ZEALAND - A SURVEY OF PUBLIC ATTITUDES December 1988		22.50
FISCAL POLICY 1989/90 March 1989	(out of print)	22.50
RETIREMENT INCOME PROVISION March 1989		33.75
REVIEW OF THE OPERATION OF THE LABOUR RELATIONS ACT IN THE 1988/89 WAGE ROUND April 1989		5.60
INDUSTRIAL DEMOCRACY - A CASE FOR REGULATION OR DEREGULATION? May 1989		33.75
SUBMISSION TO THE WORKING PARTY ON EMPLOYER FUNDING CONTRIBUTION TO TRAINING June 1989		11.25

RESERVE BANK OF NEW ZEALAND BILL - SUBMISSION TO THE FINANCE AND EXPENDITURE SELECT COMMITTEE July 1989	11.25
DISASTER INSURANCE POLICY July 1989	22.50
THE ANTITRUST DEBATE IN NEW ZEALAND - COMMENTARY : PROFESSOR W A BROCK August 1989	7.00
PORTS AND SHIPPING REFORM IN NEW ZEALAND - CURRENT DEVELOPMENTS AND FUTURE REQUIREMENTS September 1989	33.75
ECONOMIC AND SOCIAL POLICY - NEW ZEALAND BUSINESS ROUNDTABLE SPEECHES AND PAPERS September 1989	33.75
PHARMACY BILL - SUBMISSION TO THE COMMERCE AND MARKETING SELECT COMMITTEE January 1990	12.50
DISASTER INSURANCE BILL - SUBMISSION TO THE COMMERCE AND MARKETING SELECT COMMITTEE January 1990	12.50
TOURISM : WHAT INCENTIVES FOR GROWTH? - A STUDY OF LABOUR ISSUES AFFECTING THE OUTLOOK FOR TOURISM January 1990	33.75
MERGERS AND TAKEOVERS IN NEW ZEALAND - MANDATORY CLEARANCE REVISITED February 1990	22.50
SUBMISSION ON THE COMMERCE LAW REFORM BILL February 1990	12.50
THE PURSUIT OF FAIRNESS - A CRITIQUE OF THE EMPLOYMENT EQUITY BILL February 1990	22.50
RESOURCE MANAGEMENT BILL - SUBMISSION TO THE SELECT COMMITTEE OF THE HOUSE OF REPRESENTATIVES March 1990	15.75
FISCAL POLICY AND ECONOMIC GROWTH - MUST NEW ZEALAND REMAIN A LOW GROWTH COUNTRY? March 1990	22.50
CHOICE IN THE WORKPLACE - A BETTER FRAMEWORK FOR LABOUR LAW May 1990	22.50
LIBERALISATION OF COASTAL SHIPPING June 1990	11.25

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