TURNING GAIN INTO PAIN

NEW ZEALAND BUSINESS ROUNDTABLE
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FOREWORD

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

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

It includes a paper by Bryce Wilkinson, consultant to the NZBR.

A full list of NZBR publications is also included.

R L Kerr
EXECUTIVE DIRECTOR

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WELLINGTON
25 NOVEMBER 1998

TURNING GAIN INTO PAIN

Remember 1994? That was the year that marked a decade of economic reforms in New Zealand. Pain had been turned into gain. The economy grew that year by 6 percent, having grown by 5 percent the previous year. Unemployment was dropping like a stone, inflation was down and out, the current account deficit was 1 percent of gross domestic product (GDP) and the budget was in surplus. New Zealand's achievements were getting due recognition around the world. As an editorial in *The Wall Street Journal* put it:

> Under finance minister Roger Douglas, this tiny, faraway democracy began its break from limp socialism. It was the most ambitious assault of any Western nation on the system of entrenched privileges that had made an elite rich and resulted in reduced opportunities for everyone else.

But New Zealand's socialistic past casts a long shadow, as Michael Bassett's recent excellent book, *The State in New Zealand 1840–1984*, reminds us. Nineteen ninety-four was a turning point. That year I received a letter from a major investment fund manager after a visit here. He too was enormously impressed by New Zealand's economic renaissance after what he described as "decades of socialism which [had] left the country bankrupt and desperate in the 1980s". Like any prudent investor, however, his concerns were forward-looking. "Now that most of the damage has been repaired and things are going well", he said, the country appeared to be lapsing back into its old habits. "For that reason … we are reducing our exposure to New Zealand."

By 1994 Ruth Richardson had been dumped from office. Like David Lange before him, Jim Bolger had decided that staying in the competitive race was too hard. He stopped rowing and opted for the job of helmsman, but sadly his steering skills were no better. New Zealand has been drifting ever since and is now dangerously close to the rocks again.

In 1994, both economic growth and business confidence peaked. Soon after the public sensed that things were on the wrong track. In the regular *Insight* poll those who believed New Zealand was heading in the right direction peaked at 57 percent in August 1995. The number has fallen steadily to 25 percent today.

It's not hard to see why New Zealand is again in deep trouble. Key failures of Sir Robert Muldoon – the Great Spendthrift and Timid Gradualist – were repeated by his National Party successor. The massive blow-out in government spending began in 1994 and was exacerbated by the coalition agreement. Policy paralysis set in that year and was made worse by MMP (Mixed Member Proportional electoral system). Even our near neighbour, Australia – second only to New Zealand as an economic under-performer – has moved ahead with deregulation, privatisation, tax reform, central bank independence and government spending restraint, which has yielded a budget surplus. The consequences for New Zealand of four years of economic mismanagement, combined with a difficult external environment, are an economy in recession, unemployment on a rising trend, a weak external account, a credit rating downgrade, a steep fall in the currency, a budget that is back in deficit again and, most telling of all, a big outflow from the country of talented people.

What is extraordinary is that many New Zealanders have not figured out that the story of our economic life since 1984 has been one of two waves of reform, followed respectively by a teabreak and a long lunch. Jim Anderton, for example, thinks it's a story of "15 years of failed policies" and would take us back to the pre-1984 era.

What this view completely overlooks is Jim Bolger's departure from a disciplined economic framework, partly in response to the Alliance Party's success in the 1993 election, and the further departure under the coalition with Winston Peters, whose explicit goal was to 'moderate' what he maintained were 'harsh', 'uncaring' policies. He manipulated a gullible electorate and got what he wanted, and his $5 billion spending package was the final straw in 'moderating' the economy to a standstill.

A couple of other issues need to be put in perspective.

First, the idea that New Zealand's reform programme has 'failed' is ludicrous. By any standards it was a remarkable achievement. Prior to this year New Zealand enjoyed 20 out of 21 quarters of continuous expansion. From the end of 1991 until last year the economy grew by around a quarter. Even with the recent drop in employment there are now 268,000 more jobs than at the end of 1991 – an increase equivalent to two-thirds of the jobs in the whole of the South Island. Net government debt has been halved to under 25 percent of GDP and net official foreign currency debt has been totally repaid. Company balance sheets are much stronger. Despite the recent slippage, the results of nearly a decade and a half of reform have enabled New Zealand to weather the present international financial turmoil. Without them we would be looking like Thailand today.

Secondly, the rhetoric since 1994 about 'softer' policies has been economic rubbish and political humbug. We should judge policies by their results, not their labels. The results have been a setback to the prospects of the least well off, rising unemployment and few benefits from pouring billions of extra dollars into dysfunctional health and education systems. Moreover, when it came to New Zealand First there was not even any pretence about helping the poor – the vast majority of the benefits of its spending initiatives went to wealthy superannuitants and other better-off groups in a naked vote-buying exercise. So much for MMP and its incentives to pander to interest-group politics.

In October 1997 Jim Bolger finally seemed to hear the wake-up calls and responded with his 'Springtime' speech. But he was still in dreamtime – even though the Asian crisis had struck several months earlier and the policy framework was falling apart, he thought New Zealand would achieve 4 percent growth this year, whereas we will be lucky to see any growth at all.

Twelve months down the track the government and the Reserve Bank are still telling us – for the third year in succession – that a recovery is just around the corner. This time the upturn is supposed to be driven not by tax cuts and the AMP demutualisation, but by lower interest rates and a pick-up in exports. This could again be illusory: the worst of the international turbulence may not be over, policy directions remain confused and election uncertainties may soon be upon us.

No coherent programme to put the economy back on track has materialised since Jenny Shipley took over. Some initiatives which were in the pipeline, like the decisions on tariffs and ACC have gone forward, and the proposed sale of Contact Energy is welcome. But much of the rest of the agenda in the prime minister's February statement has gone nowhere: the Code of Social and Family Responsibility is in tatters, efforts to fix the Employment Contracts Act 1991 were abandoned, hospital reform has been put on hold for three years, the Auckland Regional Services Trust exercise was a fiasco and nothing has been heard about a Regulatory Responsibility Act. Next month's Budget Policy Statement is likely to show the government spending ratio rising instead of falling towards the government's goal of 30 percent of GDP. Good tax policy principles are being abandoned with the decision to fund the ACC 'tail' with a payroll tax to make the government's battered accounts look better. Another spring has come and gone and the economy's plight reminds me of the banal words attributed to the Victorian poet laureate, Alfred Austin, written at the time of the illness of the Prince of Wales:

> Across the wires the electric letters came
> 'He is not better, he is much the same.'

Now the government is talking about easing the pace of reform with next year's election coming up. How it can go much slower is surely a mystery to most of us in business. A symbol of the government's work rate is that a minor initiative, which it announced as one of the highlights of its 1997 budget 18 months ago, the sale of its vehicle testing stations, has still not gone through. Lacking a strategy, it has become an easy prey to any interest group that decides to challenge it. Backing off roading and producer board reform certainly won't help the economy. Experience seems to show that governments that capitulate to interest groups and lack principle and commitment don't help their political fortunes either.

On the other side of politics there has been much talk recently of a swing to centre-left governments in a number of countries, of a reaction against economic liberalisation (for example in Asia) and of yet another search for a so-called 'third way'. There is a lot of confusion in my view in such interpretations.

For a start, the idea that the election of centre-left governments in Britain and several European countries means a reversal of the policy directions of the past two decades seems to me totally misconceived. Tony Blair positively embraces the Thatcher legacy: 90 percent of Blairism seems, so far, to be Thatcherism with a smile instead of a handbag. The new German government is talking about labour market and welfare reforms and tighter fiscal policy, and an ex-communist prime minister in Italy is pressing ahead with privatisation, as is the socialist government in France. President Clinton has carried on where Ronald Reagan left off and has presided over welfare reforms that Reagan never contemplated. Many of these countries are still attached to dubious economic policies but none is talking about going backwards. Both Blair and Clinton are strongly and visibly pro-market and pro-business.

By contrast, the centre-left parties in New Zealand display no such instincts: their inclinations are to disown the legacies of the 1980s, embrace a backward-looking programme, abandon privatisation, and emphasise taxation and income redistribution rather than enterprise and wealth creation. It would simply not be credible for the present Labour Party to try to brand itself as 'New Labour': it has failed 'Old Labour' written all over it.

As far as Asia is concerned, I believe the lessons are also being read wrongly in the same quarters. The problems in Asia are not a failure of economic liberalisation: to the contrary, they revolve around policy failures with regulated exchange rates and financial market controls, political cronyism and serious weaknesses in banking systems and corporate governance. At the Pacific Rim Forum I attended in 1998 in Shanghai, along with some 500 heavy hitters from around the region, there was no inclination whatsoever to retreat from a globalised and integrated world economy, despite its strains and challenges. To the contrary, the strong message was that efforts to free up trade and liberalise markets must continue: there is no place to hide. The prevailing view was that Japan is in chronic need of deregulation and Malaysia's agony will get worse if it tries to swim against the tide for long.

It is true that in Australia we saw a Labour Party going into an election in 1998 with a protectionist, high-spending and backward-looking programme. But the soft options it offered were rejected by the electorate in favour of a government that campaigned explicitly on a pro-reform agenda, including the politically difficult issue of tax reform. As one commentator saw the result, the argument of Pauline Hanson and others that:

> … the Australian electorate is tired and frightened of reform … is dead and finished and should never be mentioned again.

It is a fact of life that no country is going to prosper in the modern world if it doesn't embrace continuing change. Change is inexorable, and all growth depends on it. It is no use clinging to anachronistic producer board structures. They may have made sense when

New Zealand was exporting a handful of commodities to one market, but they make no sense when we are dealing with sophisticated food markets in all parts of the world. It is no use complaining about welfare dependency when 30 years of experience tells us that our present welfare system will continue generating more and more dependency if it isn't changed. We have to face up to such challenges if we want to make progress. And we must do so continuously: countries that, like the proverbial hare, just put on a spurt from time to time and then take time out for a nap still end up losers.

If New Zealand wants to succeed, it has to become a competitive nation whose diverse people are confident about doing business with the world and are well equipped to do so. It must accelerate the removal of obstacles to business enterprise and so improve the rewards from work, saving, investment and education. It must downsize all levels of government, which still appropriate 40 percent of national income, and lower taxes. The world will continue to change, with or without New Zealand. If New Zealand fails to meet these challenges, its people will not be secure, let alone prosperous enough, to provide the resources to look after those who genuinely need help.

We know that New Zealand has the potential to be a first-class country. We proved that in the mid-1990s, when the economic framework finally became balanced and consistent. That period stands as a benchmark against which subsequent performance can be judged. Fortunately the reforms lasted long enough for New Zealanders to be able to see that pain could be turned into gain. The benefits were not just theoretical, and with falling unemployment, a start to real wage increases and then tax cuts targeted at low-income earners, they were spreading widely. The tragedy is that the country has subsequently learned that through sheer mismanagement gain can equally be turned into pain.

In my business career I have discovered that there are two ways to arrive at a sound business strategy. One is to use your brains, think hard and logically, listen to good advice and go for the best quality decision. The other is to learn the hard way: don't do your homework, make mistakes and then painfully remember never to repeat them. I have done both and I know which is less costly.

New Zealand now faces similar choices. Over the past few months I have been struck by the number of business colleagues who feel as frustrated as I do about the country's slide back into mediocrity. Many have begun to think that the only way out may be for New Zealanders to have to learn the hard lessons all over again. Personally I have not quite reached that position. Continued drift or, worse, a return to backward-looking policies would have huge costs. They would not fall primarily on investors, who have already been putting their money somewhere else, or on skilled and mobile people who can vote with their feet – as so many of them have recently been doing. They would fall instead on the unemployed, the unskilled, the elderly and others who don't have such options. Those people don't deserve that fate.

I believe we ought to have the wit to choose better. All political parties should be able to recognise the essentials of modern economic growth: providing a stable, neutral environment for savings and investment; reducing the size of government; opening markets to trade and competition; respecting property rights and the rule of law; not burdening the productive sector with unnecessary regulations and controls; and building human capital through flexible labour markets and sound education. The New Zealand Business Roundtable and the Wellington Regional Chamber of Commerce set out such an agenda in the report *Moving into the Fast Lane* two and a half years ago. It is as valid today as it was then. We must continue to challenge political parties to take it up or to tell us why they disagree with it.

Professor Michael Porter of Harvard University had similar advice when he was here in November 1998. He felt that New Zealand had made huge strides since his visit in 1991: the economy was more stable, we had got rid of many unnecessary government activities and businesses were better run and managed. But he observed that we seemed to have stalled, that antiquated institutions like producer boards were still in place and that we needed a new vision and momentum.

Porter argued that there is – or should be – little political debate about most substantive policy issues and that there is no gap between economic and social policies. And he made another point which I think is very important. He suggested that what separates nations today is their ability to do things. By that he meant the quality of their political and business leadership, their ability to develop an achievement orientation and their willingness to embrace ongoing change. He stressed the need for a vision, for political parties to spell out a framework for the electorate and to say what they believe in and what they want to achieve. I agree with him that New Zealand desperately needs political and business leadership to show the way forward. And I know of no successful country where politicians and the business community are at odds.

But is anyone listening – to Porter or anybody else? I see little sign of it. How many people passionately want New Zealand to be an exciting, dynamic place and are willing to strive to make it happen? Where is the concerned and articulate media alerting the country to the dangers it is facing? There is no reason why the country should drift on to the rocks – but where is the will to salvage the situation?

Like Russia, New Zealand seems to find it hard to escape its history – just listen to the arguments at any Grey Power rally. Many of the same generation that ran the country into the ground by the early 1980s push an agenda that would do the same again – and among other things lead to further cuts in pensions down the track. There is something in the Kiwi psyche that is uncomfortable with success – we would rather tear down achievers than applaud them and seek to emulate them. Unless that changes, mediocrity is likely to remain our fate. And unless the community comes to terms with the policy slippage and the paralysis of MMP and insists on change, my prognosis for New Zealand is bleak. Before we know it we could easily be facing an economic crisis again. In that event the process of turning gain into pain will not be at an end.

GREENWICH FINANCIAL SERVICES CLIENT FUNCTION

GLOBALISATION, ASIA AND IMPLICATIONS FOR NEW ZEALAND

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NEW ZEALAND BUSINESS ROUNDTABLE

AUCKLAND
9 DECEMBER 1998

GLOBALISATION, ASIA, AND IMPLICATIONS FOR NEW ZEALAND

Globalisation is a word that we have all become familiar with over the past decade. Recently I came across a passable description of the phenomenon. It reads as follows:

> Modern industry has established the world market … [which has] given a cosmopolitan character to production and consumption in every country. … [I]t has drawn from under the feet of industry the national ground on which it stood. All old-established national industries have been destroyed or are daily being destroyed. They are dislodged by new industries, whose introduction becomes a life and death question for all civilised nations, by industries that no longer work up indigenous raw material, but raw material drawn from the remotest zones; industries whose products are consumed, not only at home, but in every quarter of the globe. In place of the old wants, satisfied by the productions of the country, we find new wants, requiring for their satisfaction the products of distant lands and climes. In place of the old local and national seclusion and self-sufficiency, we have intercourse in every direction, universal inter-dependence of nations.

You may be wondering who wrote this? Candidates that come to mind might be critics of globalisation like John Kenneth Galbraith, Noam Chomsky or our very own Jane Kelsey. Perhaps the language gives it away: the writer was Karl Marx (with his co-author Friedrich Engels) in *The Communist Manifesto* of 1848.

Three points are worth making about Marx's account of globalisation.

First, he was in no way opposed to it. To the contrary, Marx saw that the growth of modern industry in the previous hundred years had created "more massive and more colossal productive forces than have all preceding generations together". It had drawn "even the most barbarian nations into civilisation" and "rescued a considerable part of the population from the idiocy of rural life". Marx did not want to stop globalisation, but he thought its benefits flowed disproportionately to bourgeois capitalists rather than oppressed workers. He wanted private property abolished so that the benefits could be enjoyed by all. Faith in the unfortunate experiments that Marxism spawned largely came to an end when the Berlin Wall fell in 1989.

Secondly, Marx's observation reminds us that globalisation is by no means new. As David Henderson, a former senior OECD (Organisation for Economic Cooperation and Development) official, stated in a 1997 study for the New Zealand Business Roundtable last year entitled *New Zealand's External Economic Policies*:

> The outstanding historical case of full integration is that of the United Kingdom in relation to the international economy over the period from 1850 to 1914. By mid-century the United Kingdom had established virtually full freedom, not only of trade and capital flows but also of migration, and this regime was effectively maintained up to the outbreak of the First World War. During this same period, in the world economy more generally, capital flows were almost wholly free (and exchange controls unknown), immigration controls were light or non-existent (though tending to increase), tariffs and trade preferences were mostly moderate (though also on an upward trend, from the late 1870s), and non-tariff barriers to trade were negligible.
>
> Hence the period provides a leading instance of unilateral full integration of a single country within a generally liberal international economic order such as may now be in course of being realised once again.

It is interesting to note some of the features of this nineteenth century liberal international order. In the decade prior to 1914, Britain's net foreign investment was 8 percent of its gross domestic product (GDP) and half of its gross national savings. By 1914 a third of Britain's capital stock was invested abroad, a proportion of national wealth dwarfing anything seen anywhere today. Late last century citizens could travel from London to Moscow without a passport, and take up residence anywhere along the way. And by comparison with the twentieth century, the second half of the nineteenth century was an era of international peace.

But this liberal stance did not survive the advent of the First World War, which propelled collectivist experiments around the world. It was dealt a further massive blow by the Great Depression of the 1930s. A third point to take from Marx is his belief that capitalism was subject to periodic crises which would ultimately lead to the breakdown of the system. To many people the 1930s depression seemed like the fulfilment of Marx's prophecy. It intensified the trend towards state intervention and cast a shadow over political and economic thinking in New Zealand and many other countries for another 50 years.

Of course, what a massive amount of scholarship has established beyond reasonable doubt is that, far from showing that 'capitalism doesn't work', the Great Depression was a colossal and tragic failure of government and public policy. As a 1998 study by Lawrence Reed entitled *Great Myths of the Great Depression* summarises it:

> The genesis of the Great Depression lay in the inflationary monetary policies of the US government in the 1920s. It was prolonged and exacerbated by a litany of political missteps: trade-crushing tariffs, incentive-sapping taxes, mind-numbing controls on production and competition, senseless destruction of crops and cattle, and coercive labour laws, to recount just a few. *It was not the free market which produced twelve years of agony; rather, it was political bungling on a scale as grand as there ever was.*

Against this background, it is extraordinary that some people – particularly the critics of globalisation – have rushed to paint the Asian economic crisis as another 'crisis of capitalism' and advocated many of the same mistaken moves towards autarchy that exacerbated the Great Depression. An extreme case is Tim Hazledine of the University of Auckland, who wrote early in 1998 that:

> Now is a very foolish time to be preaching the virtues of internationalism and globalisation, with all the repercussions of the collapse of the 'Asian Miracle'. Should it not occur to our leaders that, were we less dependent on investment and trade with these countries, both imports and exports, we would equivalently be more able to set for ourselves an economic course more resistant to buffeting from events outside our control?

Chalmers Johnson, an American academic who also espouses protectionist policies, has written that "if there's anything that's dead in the water in Asia right now, it's the idea of globalisation". Paul Krugman and George Soros have argued for capital controls, Bryan Philpott has recommended Keynesian interventions, Jane Kelsey views the APEC response of pressing on with liberalisation as the folly of "the New Zealand experiment writ large" and others have poured scorn on those who saw the Asian 'tiger' economies as holding lessons for economic success.

Much has been written on the Asian crises, and no doubt there will be more interpretations and insights in the years to come. I do not propose to traverse that ground here, but instead to concentrate on some aspects that seem relevant to economic debates in New Zealand. There are four basic points I want to make.

First, nothing in the present crises nullifies the achievements of the leading Asian countries in the post-war period. They have quadrupled living standards and lifted their populations from grinding poverty to average income levels that in some cases far outstrip New Zealand's. That remains the case despite the present setbacks. Prosperity has been widely spread; the most competitive societies, such as Taiwan, have a more even income and wealth distribution than the welfare states of the West. And they have achieved economic success despite an almost complete absence of natural advantages in most cases.

Secondly, the Asian countries that attracted attention were Japan and then the four so-called 'tigers': Hong Kong, Singapore, Taiwan and South Korea. No one saw Indonesia as a model of development, despite its considerable achievements. Common to all the leading countries was a story of progressive economic liberalisation. A 1993 World Bank report put the emphasis on sound fundamental policies and increasing openness, although it concluded that in a few cases selective interventions had had positive results. Such interventions can work as long as the planners can simply imitate what has been successful elsewhere. But imitation is no longer possible for the advanced Asian economies, and in any event has led to huge over-capacities in industries such as electronics and cars. That is why the World Bank made a point of warning other countries against experimenting with selective interventions. The World Bank's verdict in its new report, *East Asia: The Road to Recovery*, is more outspoken: it argues that reliance on the visible hand led to bad governance, corruption and crisis.

A further point is that the freest and most flexible Asian economies appear to be weathering the storm best. The latest Heritage Foundation index of economic freedom ranks Hong Kong, Singapore and Taiwan in first, second and seventh place respectively out of 154 countries; all three appear to be adjusting to the crisis, although Hong Kong's economic framework may be in some doubt in the longer run. Next come Japan in fourteenth position and South Korea in twenty-fourth place; both are more corporatist and rigid economies and are struggling to regain momentum. Malaysia and Thailand come further down still, and Indonesia is in sixty-second place. Of this last group, only Thailand has reacted in a generally coherent and liberalising way and appears to have the best prospects of early recovery.

Thirdly, although other factors including an element of contagion may have played a part, my reading and that of the World Bank today is that – like the Great Depression – the Asian crisis is primarily a government-made phenomenon. It appears to have had its origins in fixed and over-valued exchange rates and other financial market controls, activist industry policies and the 'Confucian corporatism' that went with them, and a lack of transparency in banking and corporate governance. As John Goulter summed it up in *The Press* after a visit to Asia earlier this year:

> The Asian miracle faltered not because its economies were too exposed or had embraced international competition too freely, but pretty much the reverse. People with any experience of business in Asia have been complaining for years about restrictive trade practices, 'crony capitalism' that has closed deals to outsiders and rigid control of economies by 'Think Big' governments.

It is also interesting that the World Bank, in analysing the roots of the crisis, is now focusing on the lapses in competition and openness in Asia that gave rise to corruption and political opportunism:

> Corruption and poor institutional performance shoulder much of the blame for the crisis … . In the decades of extraordinary growth, corruption co-existed with reasonably effective institutions, from core macroeconomic management to schooling services. Now most observers are concerned that public institutions are largely ineffective and driven more by private gain than the public good … .

The World Bank is recommending institutional reforms such as less state involvement in credit allocation, proper bankruptcy law, reforms of banking regulation and reduced restrictions on foreign ownership.

Fourthly, in response to the crises, most Asian governments have set about trying to fix these mistakes. To the chagrin of the critics of globalisation, most have not reversed direction – instead they have floated their exchange rates and taken other steps towards liberalisation and regulatory reform. Malaysia is the main exception. Even Lee Kuan Yew has stressed the need to deregulate further, not to build higher fences. President Estrada of the Philippines also recently called for deeper reforms and rejected currency controls that in the Philippines had only promoted "corruption and the black market". Although the recent APEC leaders' meeting was no triumph, there was no abandonment of orthodox macroeconomic policies and no hint of departure from the principles of free trade.

Such reactions are certainly in line with modern economic insights. The heart of the APEC project is freedom of trade and investment. The weight of economic thinking supports openness in both cases. This was true before the crises and remains so now.

In respect of trade, a great deal of economic research has documented the benefits of a liberal regime for economic growth. As David Henderson explains:

> Standard economic analysis points to the gains that can be realised within an economy where people and firms can use the opportunities which openness provides – for specialisation in more productive lines, for more pervasive competition with the stimulus to good performance that this brings, and for access not only to wider markets but also to new ideas, information, methods, products and techniques. Over the past half-century, events and experience, and the further development of economic ideas which partly resulted from them, have given greater weight to this line of thinking, both within the economics profession itself and in public opinion more generally.

Support for such views is widespread and eclectic: Adam Smith, Marx and Keynes (despite some mid-life lapses) were all free traders. It should be incumbent on academics who dispute such conclusions (like Tim Hazledine and Jane Kelsey) to submit their theory and evidence to the scrutiny of their peers in recognised academic journals before expecting the public at large to accept them.

In respect of freedom of investment flows, the arguments are similar. Investors and savers both benefit when capital can be put to best uses at home or abroad. Open capital markets allow diversification and spread risk. Practically all developed countries have liberalised their foreign investment regimes and exchange controls in recent decades. There are occasional calls for a reversal of such policies, such as those by George Soros. There may be an element of self-interest in his views, however – many of his successes have come from outmanoeuvring governments and central banks maintaining fixed exchange rates and capital controls. However, there is no sign that developed country governments are taking any notice of these views. Liberalisation of capital flows in countries in the OECD area, and a growing number of others too, is here to stay.

The recent turmoil in Asia and earlier episodes in Latin America have led some observers to suggest that developing countries – or at least those with fragile domestic financial sectors and incomplete transitions from the plan to the market – should maintain some form of controls on short-term capital flows. There is general agreement that long-term direct investment is beneficial, but concern about so-called short-term 'hot money'. In the case of developing countries, the problem is compounded by the 'moral hazard' associated with the operations of the International Monetary Fund (IMF) – in particular its willingness to bail out governments and even private banks. (Arguably the best solution to this problem would be to abolish the IMF.)

In general, I believe the case for maintaining even short-term capital controls is weak. Capital controls were one of the disastrous reactions to the financial market crisis of the 1930s, and exacerbated the depression. To be sure, issues arise about the method and sequencing of removing restrictions on capital flows, which New Zealand had to consider when it worked through a programme of dismantling interest rate and exchange controls, deregulating the banking sector, floating the currency and establishing a prudential regime. But capital controls of any kind are inevitably distorting and usually ineffective. Chile has maintained some capital restrictions but its short-term interest rates have been five times more volatile than interest rates in neighbouring Argentina which abolished all capital restrictions in the early 1990s. In the past year both Chile and Brazil, which also maintained restrictions, have moved to ease them.

A major problem with capital controls, as Asian experience has shown, is that governments can use them to rig markets for political ends. In a recent article in the *National Business Review* entitled 'Global capital: friend of masses, enemy of despots', Christopher Lingle pointed out that open capital markets provide citizens with a financial vote of confidence or no-confidence in their rulers. Echoing Marx, he wrote:

> A spectre is haunting authoritarian regimes in East Asia and stalking inept leaders everywhere. That force is global capital … the sum of actions taken daily by millions of individuals in placing money with local banks or mutual or pension funds.

Contrary to Marx, Lingle pointed out that arguments that global capitalism only benefits the wealthy are contradicted by the fact that moves in the direction of the market have lifted a billion people above starvation over the past 30 years. Such an immense gain for the poor, he maintains, is alone a sufficient argument for not changing the rules for the emerging global capitalism.

None of this is to argue, of course, that governments – authoritarian or democratic – have no choices about the internationalisation of their economies. Arguments that globalisation eliminates national sovereignty are quite overdrawn. Communities and nations are sovereign in creating the rules they wish to adopt. Governments retain wide freedom of action in matters such as defence, foreign policy, cultural affairs and legal systems, as well as economic policy. New Zealand remains as free as it ever was to borrow excessively, tolerate inflation, subsidise uncompetitive industries and join or leave APEC. But governments have to live with the consequences of their actions, and we know that different rule systems produce very divergent economic outcomes. If you adopt Cuban rules, you get Cuban growth and child mortality; if you adopt Hong Kong rules, you enable millions of refugees to prosper. Power is inevitably constrained by what works and what doesn't in a world where individuals and organisations are free to respond to what governments do. If a country attempts to seal itself from the world, like North Korea or Myanmar, the result is simply tyranny and poverty.

An increasing number of observers are suggesting that most East Asian countries are stabilising their financial systems and are poised to resume growth. I do not know whether they are right or not about the timing – banking crises leave a long trail of havoc in their wake. I think there is little doubt, however, that the most outward-looking Asian countries and those that are speeding up efforts to liberalise will recover fastest. Japan may be another story – I find it hard to understand why its latest attempt at Keynesian remedies will be any more successful than previous ones. I also suspect that China's still highly controlled economy and state-run banking system is a recipe for misinvestment of the kind seen in other Asian countries and may lead to similar convulsions further down the track – although the new Chinese leadership clearly recognises this problem and is starting to let state enterprises and banks go broke. But in general the things that have made for Asian economic success – small government, limited state welfare, low taxes, high savings, prudent monetary policies, openness to trade and sound education – have not gone away. If the present crises serve to strengthen the commitment of Asian countries to such ideas and to hasten efforts to correct the mistakes, they may well emerge even stronger.

Reactions in this direction can be seen elsewhere. In a recent article on Latin America, *The Economist* suggested that:

> In several countries, financial stress is in fact likely to stimulate swifter market reform. Brazil's government at last this month won congressional approval for its much resisted pension reform. It plans new laws to make the labour market more flexible. Ecuador, like Venezuela an oil exporter, this year embarked on a long-postponed stabilisation programme, involving privatisation and an IMF agreement. Chile has approved a law to cut its already low import duties. Several countries, including Guatemala and Argentina, are pushing on with privatisation.

In the light of these reactions, the notion that is sometimes put about in New Zealand that moves here and elsewhere in the direction of economic liberalisation have been 'extreme' and that 'the pendulum is swinging back' seems quite without foundation. Sadly, the truth is that New Zealand is now lagging as an economic reformer.

The Asian experience highlights the enormous benefits of New Zealand's earlier reforms in helping it to withstand the recent international turbulence. The clean float of the currency has meant that any would-be speculators are not betting against the central bank but against other players in the market – thus New Zealand has not been a happy hunting ground for the likes of George Soros. The commitment to price stability and an independent central bank have been major assets. The greatly reduced level of public debt has helped sustain investor confidence. The privileges and favouritism of the Muldoon era – New Zealand's equivalent of crony capitalism – are no more. Our banks face market disciplines. Without an open and transparent financial system and a much improved fiscal position, New Zealand would be faring much worse than it is.

The Asian crisis holds other lessons for New Zealand. One is that it is easy for a country to fall from grace. It cannot be denied that, as a consequence of globalisation, the margin for policy error is now much narrower. One might have thought that the property market bubble in Hong Kong – partly due to government land controls – was not necessarily a capital crime, but Hong Kong has not escaped a hammering. New Zealand's margin is now too narrow for comfort. Thanks to the policy slippage of recent years – particularly the massive growth of government spending and the failure to maintain international competitiveness – we have a current account deficit of Asian proportions, a high level of external debt and a downgraded credit rating. We are unduly vulnerable to further possible shocks from abroad, such as a slump in Japan, turmoil in China or a large fall in the US stockmarket.

But the final and most important lesson from Asia is not a new one. It concerns the ongoing quest for higher living standards. This is a quest that has no end, so long as people look for improvement in their lives. Improvement depends on adaptability, on the kind of economic environment favourable to innovation and change that has been the source of Asian dynamism and progress. New Zealand resisted change for many years, and the leading Asian countries and many others overtook us. We embraced it for a time with the economic reforms of the 1980s and early 1990s, but then decided continuing adaptation was too hard and opted for another of our perennial teabreaks. Asian countries appear to be facing up to the need for further restructuring, while some in New Zealand talk about reform fatigue and call for a moratorium on change. If governments heed their calls they should not complain when living standards stagnate, unemployment rises and our best and brightest leave for Australia or further afield.

For the reality of globalisation today, just as in the nineteenth century, is that capital and increasingly labour move to where the opportunities are greatest – and they do so faster given modern information, transport and communications systems. New Zealand has done little to adjust to events in Asia, barring some minor reductions in government spending plans. Large tracts of the economy such as those occupied by state and local government enterprises and single-desk producer boards remain closed to international influences and investment. The opposition parties are promising policies which are backward and inward looking: I know of no economist who believes they would be positive for growth. Meanwhile other countries, including many in Asia, are pressing on with reforms and improving the prospects for their citizens.

Earlier this year, the Geneva-based World Economic Forum published its global competitiveness report for 1998. Two years ago it ranked New Zealand in third place in an international survey of economic competitiveness, calling it a star. Last year we had fallen to fifth place, and we are now down to thirteenth. Just last month *The Economist* published a survey evaluating the best countries in the world in which to conduct business. New Zealand fell from seventh position in the previous league table to fifteenth place. Australia is now ahead of us, and many European countries are moving up because of their improved macroeconomic performance and continued deregulation. These are just the latest of many indicators over the past five years that tell us that New Zealand has been losing ground after its earlier achievements. The warning bells are getting louder. But is anybody listening?

OTAGO CHAMBER OF COMMERCE AND INDUSTRY

THERE'S SOMETHING (WRONG) ABOUT TINA

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DUNEDIN
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THERE'S SOMETHING (WRONG) ABOUT TINA

In a *Forbes* magazine column a few years ago, the American economist Thomas Sowell wrote:

> If there were a prize for the most dishonest phrase in politics, the competition would be fierce and the outcome very uncertain. However my nomination would be the phrase 'trickle-down economics.' The trickle-down theory is supposedly the notion that the way to benefit the poor is to have the government provide benefits to the rich, which will then trickle down to the poor. But there is simply no such theory – not in Adam Smith, not in John Maynard Keynes, not in Milton Friedman. Not in anybody.

To my knowledge, no serious participant in public debate in New Zealand has ever espoused the notion of 'trickle-down economics'. Yet that has not prevented people from Ken Douglas to Kim Hill applying the label to this country's economic reforms.

An equal candidate for the prize for dishonesty in a New Zealand setting is TINA. Critics of the reforms say that supporters claim that 'There Is No Alternative'. Again, I know of no one who has ever made that claim in the sense that it is meant – some kind of dogmatic belief in the 'One True Way'. Yet the allegation is recycled time and again – most recently, for example, in a book by University of Auckland Professor Tim Hazledine.

Strictly speaking, New Zealand had a choice of sorts even in the mid-1980s. Even though its command and control economy was rapidly seizing up, it could have applied more band-aids and staggered on a bit longer. Nothing has so far forced Cuba and North Korea to change direction. But the price for New Zealand would have been high – a continuing slide in relative living standards, growing debt and increasing risks of economic crisis. The reality was that New Zealand had to change direction if it wanted to stay in the ranks of advanced countries.

I think few New Zealanders under 60 years of age would have much argument with that proposition. Nancy Devlin, an economist at the University of Otago, recently wrote that for students today:

> … the pre-1984 period seems to be viewed as a kind of quaint aberration from common sense. Contrast this to our experiences as undergraduate students in New Zealand in the early 1980s: learning about the workings of free markets was like listening to wonderful 'theory tales': it sounded compelling but there was no evidence that such things really existed.

It is also worth noting that there is not a single Organisation of Economic Cooperation and Development (OECD) country that has not gone in the same general direction as New Zealand. Efforts to curb inflation, bring more discipline into public finances, reduce high tax rates, deregulate markets and privatise state-owned businesses have been common to all of them, and such trends extend well beyond the OECD. I do not see the recent turmoil in some Asian countries reversing these trends. If anything, I suspect it is likely to give a new impetus to liberalisation, as indeed we have already seen in several Asian countries.

But to argue that there was no alternative to change but stagnation and crises is not to argue that some detailed set of alternative policies was preordained. At the outset many choices had to be made about how to exit from the wage and price freeze, and about the speed and sequence of moves to free up the economy. Not all of them were well made – the Labour government's refusal to deregulate the labour market, for example, caused much unnecessary unemployment. Even supporters of limited government recognise that, on an ongoing basis governments have to make choices on a vast range of economic and social policies. The choices can and should vary in the light of developments in economic understanding, prevailing values, changes in the world around us, technological developments and a host of other factors. Moreover, the choices are not static or, to put it another way, there is no end to potential reform if we are interested in ongoing improvements. For example, there are obviously different options for running our telecommunications and roading systems today than there were 30 years ago.

What's more, there has been vigorous and open debate about the reform programme, both by opponents and supporters of its general thrust. Such debate is healthy, vital and will certainly continue. It is absurd to suggest that it has been suppressed – can anyone seriously suggest trying to suppress Gareth Morgan, Frank Haden, Jane Kelsey or Brian Easton? And who would want to? Sound conclusions can only get hammered out on the anvil of debate. Complaints about suppression seem to come only from those whose arguments have failed to gain support.

Looking back over the past 15 years we can see that each and every one of the major reforms was fiercely opposed, usually by various academics and independent commentators as well as by interest groups. Today most command a reasonable measure of agreement or acquiescence. But along the way many alternatives were put forward, and it is interesting to see how they have fared. Let me run through a very short list of examples.

A starting point might be the Treasury's 1984 post-election briefing paper, *Economic Management*, which is sometimes seen as providing the framework for the reform programme. This was roundly condemned by a group of economists at Victoria University of Wellington. One of their major criticisms was directed at the idea of a floating exchange rate – they defended a fixed-rate regime. No competent economist would argue that floating exchange rates are the best option for all countries in all circumstances, but the overwhelming majority of economists today see them as an effective monetary arrangement for many countries. Attempts to maintain fixed exchange rates at levels that were not credible were a major cause of the recent turmoil in Asia. I shudder to think of the difficulties New Zealand would be facing today, and would have faced on many occasions in the past dozen years, had we persisted with a fixed-rate regime.

In respect of labour market arrangements, many argued in the 1980s that New Zealand should adopt an Australian-style 'accord' – a centralised agreement between employers, unions and the government. A similar Swedish model was admired at the time; Bryan Philpott was a prominent advocate of incomes policies; and, as prime minister, Mike Moore tried to introduce a variant called a 'compact'. Who pushes such ideas today? Even in Europe governments are trying to free up their inflexible labour markets.

Linked to incomes polices were old-style Keynesian ideas of manipulating the economy through fiscal policies to try to maintain a stable growth path. In 1991, 15 academics at the University of Auckland lambasted the 1991 budget saying:

> We wish to state in the strongest possible terms our view that in the present state of the economy, and in the midst of an international recession, the deficit-cutting strategy is fatally flawed. It can only depress the economy further … .

Within months the economy was on a strong, export-led recovery path, partly because of the better balance between fiscal and monetary policy. Keynesian remedies have long been thoroughly discredited. If government spending were the means of pulling an economy out of a slump, how come New Zealand is in a recession this year despite the coalition government's $5 billion spending package? And yet there are still some who haven't figured out that higher government spending is the problem not the solution, and who resist arguments to cut it.

Coming to monetary policy, we had to put up for years with those who told us that New Zealand was an aberration with its 'obsession' with low inflation. Critics like Winston Peters and Sir Robert Jones said that we should abandon ideas of price stability and target the inflation rate of our trading partners. Well, over the past 10 years most OECD countries have progressively adopted approaches to monetary policy that are in substance very similar to New Zealand's and have achieved equally low inflation rates. Many have adopted an explicit price stability objective – most recently the European Union countries that are moving to the single currency of the Euro. Even if it had any merit – which it doesn't – the suggested alternative rule would make little practical difference today.

Winston Peters also campaigned for activist 'industry policies' rather than a so-called level playing field approach under which policies do not favour particular industries. The Labour Party still promotes this alternative. One of Mr Peters' favourite models was MITI, the Japanese Ministry of International Trade and Industry. Scholarly articles going back 20 years or more have debunked the 'myth of MITI', pointing out that it was not the explanation of Japan's earlier success and that it had picked losers at least as often as winners. Subsequent events in Asia have exposed the risks of 'crony capitalism' that are always inherent in government industry policies.

Fifteen years ago a serious alternative policy strongly promoted for industry development was import protection through licensing and tariffs. Today there is a solid consensus among economists in favour of free trade. The only academic economist I know who still argues for tariffs is Tim Hazledine, and even he has been reported as suggesting a "moderate" level of 5 percent. It's hard to understand what the sound and fury is all about. Tariffs of 5 percent would barely make a difference to the competitive position of New Zealand firms in industries where low labour costs matter. Even a low tariff would mean exporters continued to be taxed, and would merely keep many bureaucrats and staff in importing firms unproductively employed in customs administration.

Another 'alternative' policy for international competitiveness that mercifully seems to have fallen by the wayside, at least for the time being, is exchange rate intervention. The leading proponent of this strategy to correct a so-called overvalued exchange rate is the former Dairy Board chair, Sir Dryden Spring, although he never told us exactly how it would be implemented – inevitably it would mean sacrificing an inflation objective. In the light of what we now know about the foreign exchange dealing losses made by the Dairy Board as a result of its hedging policy, this appears to be an example of it saying one thing and doing another, while costing farmers a bundle. Yet Sir Dryden has recently been maintaining that proposals to deregulate export monopolies are a "gigantic economic hoax"; it seems he still does not understand how competitive markets actually work.

A final example of an issue on which alternative views have been strongly contested is corporatisation and privatisation. Initially, people like Mervyn Probine, former chairman of the State Services Commission, and the public sector unions staunchly maintained that there were no benefits from corporatising departments like the Post Office. Then when the gains from corporatisation were apparent to all, the critics shifted ground and argued against privatisation. There are still many opponents of privatisation, despite the post-privatisation cost reductions and improvements in service in organisations like Air New Zealand, Telecom and Tranz Rail. At base their views reflect a lingering attachment to the socialist belief in "public ownership of the means of production, distribution and exchange". This is even more entrenched in New Zealand than in Australia, which has made more progress on privatisation in recent years.

It is apparent from this brief review that there has been no shortage of alternatives to the reforms, even if most of them haven't stood the test of time very well. Conversely, those who have broadly supported the reforms have proposed many alternatives that have not been taken up. For example, the New Zealand Business Roundtable has advocated the abandonment of state monopoly provision of accident compensation from the time of a 1987 report, yet such moves are only now being partially implemented and may yet be overturned by a Labour government. Similarly, no moves towards alternatives to producer boards have been decided. To take a different kind of example, we argued for several years against the alternative approach to education qualifications based on unit standards promoted by Lockwood Smith as minister of education. It is pleasing to see that Wyatt Creech has now abandoned it in favour of a more balanced use of external examinations and internal assessment. But in many areas of education, health and welfare policy, alternatives that we have canvassed have made little headway, yet community dissatisfaction with these services remains as high as ever.

There are also areas of economics where there can be legitimate debate about the best policies. Disagreements amongst economists are often greatly exaggerated: it would be fair to say that there is a high level of professional consensus on such things as the case for low inflation, free trade and open capital markets and on the case against price controls, minimum wages and large budget deficits. Moreover, with the abandonment of Keynesianism and central planning, there is a greater consensus today than for several decades on the policies needed for good economic performance. Nevertheless, competent economists differ within limits over issues such as the optimal level of government debt, the regulation of natural monopolies and the effects of a social welfare safety net, and there are issues such as immigration where perspectives other than purely economic ones must be considered. Another issue for legitimate debate is the speed with which desirable changes should be implemented: areas where this issue arises include lower tariffs, higher tertiary education fees and more restrictive superannuation benefits.

So, looking at the picture overall, the idea that the policy debate in New Zealand has been snuffed out by some evil fairy TINA – 'There Is No Alternative' – is rhetorical nonsense. People who engage in such rhetoric, like those who make claims about 'trickle-down economics', cannot be taken seriously as objective commentators. They may win a few propaganda battles by such tactics but they should not complain if their views gain no traction in the long run. The fate of different arguments over a long period of time should by now enable bystanders to judge between the protagonists with credibility and those without.

The issue, I have argued, is not whether there are alternatives: clearly there are, and alternatives have been vigorously promoted by all protagonists in the debates. Rather, the issue is which alternatives have merit. In economics, as in most sciences, alternative remedies are always on offer. New Zealand experimented with quack prescriptions for many years; only in the 1980s did we start adopting some conventional cures. Unfortunately more recently we abandoned the cures once the signs of good health returned and are now wondering why we are ailing again. As always in such situations, those peddling failed nostrums are quick to reappear.

As I read it, the evidence is continuing to accumulate that the countries that are faring best in the modern world are those that are continuing to work towards greater economic freedom and smaller government. Some New Zealanders have been puzzled that Australia has been weathering the recent economic storms better than New Zealand. They have failed to notice that fiscal management has improved in Australia whereas it has deteriorated badly in New Zealand, and that in many areas of economic liberalisation Australia has overtaken New Zealand or was always ahead. In the latest *Economic Freedom of the World Report*, Australia's ranking on the index of economic freedom rose to eighth position, from twenty-fourth in 1975. Ireland, another big improver, also tied for eighth place. The Asian countries which rank highest, Hong Kong, Singapore and Taiwan, are the ones that are coping best with the turbulence in that region. Also, contrary to the concerns of the critics, research suggests that economic freedom tends to reinforce social cohesion rather than damage it, and that it disproportionately benefits the poor.

So while TINA belongs in fairyland, the evidence indicates that the alternatives on offer would lead to very different futures for New Zealand. If the electorate wishes to vote for alternative remedies – for inefficient policies such as public ownership, controls on foreign investment and higher taxes – we should all be happy to respect the democratic verdict. But members of parliament, mayors, bishops and others should not then complain when problems of poverty and unemployment worsen, social services come under greater pressure and the young and mobile look for a better life abroad. Economics tells us these trade-offs are inescapable. We may choose wisely between alternatives, or not well.

NEW ZEALAND INSTITUTE OF MANAGEMENT
CANTERBURY DIVISION
CEO BREAKFAST

IS NEW ZEALAND DOOMED TO BE A LOW-GROWTH ECONOMY?

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IS NEW ZEALAND DOOMED TO BE A LOW-GROWTH ECONOMY?

The topic of this speech was prompted by an intervention at a New Zealand Business Roundtable meeting in 1998 by Alan Gibbs, a business leader who has done more than most to help make New Zealand a better place to live, work and do business. He felt that while the performance of the economy had improved since the pre-reform era, New Zealand still did not have a lot going for it. More in sorrow than frustration, and perhaps half tongue in cheek, he reflected on our attachment to mediocrity and suggested that it was slightly ludicrous to think that New Zealand would become a dynamic, high-growth economy.

Alan Gibbs's assessment is certainly consistent with the projections of economic performance on the basis of current policies. For example, in its last survey of the New Zealand economy the Organisation for Economic Cooperation and Development (OECD) concluded:

> In the absence of an acceleration in the rate of productivity growth, it is unlikely that New Zealand's per capita incomes ... will catch up to the OECD average.

The view that New Zealand may have inherent disadvantages that prevent it from becoming a high-growth economy should be distinguished from the scepticism about the benefits of economic reform that is still heard in some quarters. The OECD's projections provide no support for such scepticism. While it assessed New Zealand's potential economic growth rate to be currently only about 3 percent per annum, this is higher than the average of 2 percent growth that was achieved in the 1989–96 period, and it is about double what the economy was capable of sustaining during the 1970s and 1980s.

In addition, evidence from the experience of other countries supports the case for economic liberalisation. There was widespread cynicism about the benefits of Thatcherism and Reaganomics in the 1980s, and unfavourable comparisons were made then between the economic performance of the United Kingdom and the United States and that of Japan, Germany and France. The boot now appears to be on the other foot in these major OECD countries. The economic growth rates of the United Kingdom and the United States (2.2 percent and 2.8 percent per annum respectively over the five years ended 1996) are modest by some standards, but they compare favourably with those of Japan (1.5 percent), Germany (1.4 percent) and France (1.2 percent).

The better economic performance of the United Kingdom and United States has led to renewed optimism in these countries. A survey in 29 countries conducted earlier in 1998 for *The Economist* asked people whether they expected to be better off in future and whether they expected their children to be better off than they are.[1] A result which captured the headlines was the high ranking of some Asian countries in response to these questions, despite their recent economic problems. An equally interesting finding is the relatively high ranking of the United States and the United Kingdom – in fourth and ninth places respectively. Guess which three countries were ranked last – Germany, France and Japan.

Whether New Zealand has inherent disadvantages that may limit its economic prospects is a relevant question in assessing current policies. If New Zealand has to run harder – or maintain superior economic policies – just to stay with the pack, a rather ordinary performance might be the most we can hope for. Alternatively, mediocre performance might merely reflect a mediocre set of policies.

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1 *The Economist*, 1 August, 1998.

Reasons commonly given as to why New Zealand might be a laggard are: that this is a small country; a long way from anywhere; with an industry structure biased toward primary industries; and with skills and attitudes that are not favourable to economic success.

Let us look briefly at each of these factors.

Size

The argument that small countries are disadvantaged relative to large countries seems flawed. A large country can spread the cost of public goods, such as national defence, over a larger number of people. In practice, however, the economies obtainable in this way seem to run out quite quickly. Robert Barro, an economist who has worked extensively in recent years on factors affecting long-term economic growth, has summarised the results of economic studies on the question of country size as follows:

> There is no relation between the growth or level of per capita income and the size of a country, measured by population or area. Small countries, even with populations as little as a million, can perform well economically, as long as they remain open to international trade.[2]

You don't need sophisticated analysis to see that small countries can achieve high average income levels. Of the 25 countries which had per capita income levels higher than New Zealand in 1995, seven (or 28 percent) had a smaller population and 15 (60 percent) had a population of less than 10 million. Countries like Singapore, Hong Kong, Switzerland and Luxembourg have been outstanding economic performers.

Location

It is obvious that New Zealand is a long way from the urban concentrations of spending power in North America, Europe and Asia. This distance adds to the cost of transport and communications. Not surprisingly, there is evidence that the extent to which different countries trade with each other depends on the distance between them. There is also evidence that countries which are located close to potential trade partners tend to have higher trade sectors (relative to gross domestic product (GDP)) than other countries.[3]

However, New Zealand's locational disadvantages can be overstated. The New Zealand Institute of Economic Research (NZIER) recently asserted that "New Zealand is probably in the worst geographic position in the world to engage in trade".[4] One might get this impression by just looking at a map of the world and measuring distances, but this tends to exaggerate New Zealand's locational disadvantages.

- The cost of international ocean freight is generally lower per unit of distance travelled than the cost of land-based transport. This means that New Zealand could be in a worse geographic position to engage in international trade if it were a land-locked country.[5] Even within individual countries, high transport costs limit inter-regional trade. This may partly explain why income disparities between different regions within countries do not disappear quickly, despite the absence of any legal barriers to trade.

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2 Robert Barro, *Getting it Right*, MIT Press, Cambridge, Massachusetts and London, 1996, p 28.

3 See, for example, a study reported in J Gwartney, R Lawson and W Block, *Economic Freedom of the World 1975–1995*, The Fraser Institute, Vancouver BC, 1996, pp 35–36 and p 45.

4 NZIER, *Quarterly Predictions*, September 1998, p 37.

5 The results of the study reported in Gwartney, Lawson and Block, *op cit* suggest that a land-locked country is likely to have less involvement in international trade than a country of similar area and population with no trading partners in close proximity, unless a high proportion of its population is located near its borders.

- There are benefits as well as costs in doing business with people in different time zones. For example, New Zealand service providers may be able to meet customers' requirements more promptly because they are able to work while their competitors are sleeping.

- The Pacific Rim may become one of the most rapidly growing regions of the world in the decades ahead, despite the recent financial and political problems of some Asian economies. It is by no means clear that New Zealand's economic prospects would be enhanced if it were located closer to Europe.

New Zealand's locational disadvantages may also diminish as globalisation reduces transport and communication costs.

- Geoff Vazey, chief executive of Ports of Auckland Limited, has noted that whereas the average cost of ocean freight represented between 5 and 10 percent of Free on Board (fob) prices before containerisation, this figure has now dropped to about 1 or 2 percent.[6] With containerisation and port and shipping industry reforms, transportation costs are becoming less important. World trade in goods is increasingly dominated by manufactured products, which are becoming lighter and less bulky with the use of light-weight composites and microprocessors and by services, rather than commodities.

- The influence of location on the costs of communication, including data transmission, has been falling rapidly. The cost of a three-minute phone call between New York and London has fallen to about 2 percent of its cost in 1960 and to 0.3 percent of its cost in 1930.[7] New Zealand trends have been similar.

- The possibility of almost instantaneous low-cost data transmission means that many service activities can now be undertaken anywhere in the world where people possess the necessary skills. They include writing computer software, processing insurance claims and even some education and medical advice services. It has also become easier for people to travel to other countries to provide professional services such as engineering and architecture.

- Major corporations are changing in ways that weaken the advantages enjoyed by their countries of origin. There has been a tendency to reduce the size of head offices, to outsource activities that can be performed more efficiently by other firms, to decentralise decision-making in order to make better use of local knowledge and to scour the world for low-cost production sites.

- International trade and cross-border flows of capital are now freer than at any time since before the first world war. Substantial trade liberalisation has occurred since the 1950s through multilateral and unilateral initiatives. Progress has been made in reducing protection, even on agriculture and textiles, that had previously been relegated to the 'too hard' basket, and international trade rules have been extended to cover services. If this trend continues there is scope for further expansion of international trade. Even though trade has been growing more rapidly than world output since the 1950s, this growth has not done much more than restore the ratio of trade to GDP that prevailed in 1913.[8] There is also scope for considerable expansion of international capital flows. Despite the removal of restrictions in many countries since the 1970s, capital flows still appear modest, relative to GDP, compared with those that occurred in the 30 years prior to the first world war.

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6 Geoff Vazey, 'Address to Shipping Conference', Wellington, 29 May, 1998.

7 *The Economist*, 18 October, 1997, p 99.

8 Relative to their levels in 1913, the ratio of merchandise trade to GDP is substantially lower in Japan, slightly higher in Britain and France, and substantially higher in the United States. Source: *The Economist*, *op cit*, p 100.

This trend toward globalisation undermines the argument that New Zealand's locational disadvantages reduce its growth potential. The countries which are likely to benefit most from a reduction in transport and communication costs are those that were most disadvantaged by them in the past. Globalisation could enhance New Zealand's economic growth prospects relative to countries with fewer locational disadvantages.

It is also worth remembering that, historically, the much greater disadvantages of location that existed a century ago did not prevent New Zealand from becoming one of the wealthiest countries on earth. It is hard to see what has changed, unless it is for the better.

Resource base

There is a common view that New Zealand's economic growth potential is constrained because its industrial structure has been oriented towards agriculture. It is paradoxical that an abundance of agricultural land – a factor that once helped make New Zealanders wealthy – is now often viewed as a factor that is holding back economic growth. It is also paradoxical in that farm production now accounts for about 5 percent of GDP – although agricultural products still make up around a third of total exports.

It is indisputable that land-abundant countries – such as New Zealand, Australia and Argentina – have been among the slowest growing of the more advanced economies this century. Studies have found negative relationships between GDP growth and indexes of comparative advantage in primary and resource-based products.[9]

In a recent article, Kym Anderson, director of the Centre for International Economic Studies at the University of Adelaide, examined various arguments as to why natural resource-abundant economies might perform poorly.[10]

The main argument is the adverse effects on the terms of trade from a decline in international market prices of primary products relative to manufactures. It is asserted that this decline is due to the fact that demand for primary products is not particularly responsive to rising incomes or to price falls. Anderson points out that it is also important to look at the other side of the picture, namely the effects of relatively high rates of productivity growth in the production of primary products. He suggests that the most innovative resource-rich economies – those with the highest rates of productivity growth in the production of primary products – still have the potential to grow rapidly, despite some decline in their terms of trade.

It seems likely that New Zealand has been among the winners from increases in worldwide agricultural productivity rather than one of the losers. Total factor productivity growth, a measure that takes account of the combined productivity of capital and labour, has been estimated at 2.6 percent per annum for New Zealand agriculture over the period 1973–89.[11] This productivity performance was not only vastly superior to other sectors of the New Zealand economy, but was also better than in many other economies that are near the frontier of primary sector technology – including Australia, the United States and Canada. There is some evidence that the rate of productivity growth in New Zealand agriculture has improved further since the reforms of the mid-1980s.

It is also argued that natural resource-abundant economies grow less rapidly because their exporters face high protectionist barriers. While acknowledging that agricultural protectionism in Western Europe and Japan has tended to reduce international food prices,

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9 For example, J Sachs and A Warner, *Natural Resource Abundance and Economic Growth,* National Bureau of Economic Research, Research Working Paper 5398, Cambridge MA, 1995.

10 K Anderson, 'Are resource-abundant economies disadvantaged?', *Australian Journal of Agricultural and Resource Economics*, Vol 42, No 1, March 1998.

11 R Johnson, 'New Zealand Agricultural Policy Review', *Review of Marketing and Agricultural Economics,* Vol 64, No 3, December 1996, p 249.

Anderson points out that policies adopted by many developing countries have had the opposite effect. These have tended to depress food exports, keeping international prices higher than they would otherwise be. Some empirical analysis suggests that these effects may offset each other.

People still argue that manufacturing has unique attributes as an engine of growth. This is a peculiar view of the growth process in the light of the obvious importance of innovation in other sectors, including biotechnology and communications.

In the absence of strong reasons why natural resource-rich countries should be expected to grow slowly, Anderson points the finger at economic policies, particularly the high levels of protection governments have often provided to manufacturing industries.

A broader explanation was offered in Michael Porter's report on New Zealand's competitive advantages:

> New Zealand's factor advantages have been a mixed blessing in the long term. While enabling New Zealand to be price competitive in bulk commodities, they have also reduced the pressure on industry to develop new and more sophisticated advantages. Paradoxically, New Zealand's comparative advantages in commodity production have contributed to attitudes, strategies and institutions that make up an overall system that is not well aligned with the requirements of an upgrading economy.[12]

An issue highlighted in the Porter report is that poor institutional arrangements for the marketing of agricultural products help to explain why rapid productivity growth at the farm level has not resulted in a more respectable economic growth performance for the New Zealand economy. Producer board control has made the marketing of agricultural products in many respects a disposal activity. Farmers produce raw materials, the monopoly producer boards are essentially obliged to accept whatever is offered to them, and they dispose of the product for whatever price can be obtained on international markets. Farmers are paid whatever is left over after the boards' costs are deducted. There is no focus on profitability or on measurement of performance. Price signals are distorted in various ways, including by the bundling of investment returns into payouts to farmers. Where competition in agricultural marketing is not prevented it has often been discouraged by the potential for arbitrary intervention. The end result has been serious interference, over an extended period, with the normal market incentives for the development of new products and markets.

The government's decision to remove the statutory backing of producer boards would mean that normal market incentives could operate in this part of the commercial sector. It remains to be seen if and when this decision will be implemented. Moreover, the benefits of this move may be slow to emerge if farmer-controlled firms continue to bundle returns and restrict share transfers to discourage farmers from dealing with competitors.

Skills and attitudes

Although Michael Porter's report on New Zealand was published seven years ago, its observation that the skill base of the New Zealand workforce is low relative to that of other advanced economies is still true. Upgrading a country's human resources takes time, but there is little evidence of progress. For example:

- In the Third International Mathematics and Science Study, New Zealand's nine-year-olds came twentieth out of 26 countries in mathematics and sixteenth in science. In both subjects New Zealand was the poorest performing English-speaking country.

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12 G Crocombe, M Enright, and M Porter, *Upgrading New Zealand's Competitive Advantage*, Oxford University Press, Auckland, 1991.

- A survey of New Zealand teachers found that 59 percent would choose another career if they had the opportunity.

- There is an unwarranted complacency about the performance of educational institutions – more government spending is still commonly seen as the answer to all problems.

- There are no real mechanisms in place to force failing schools to improve. The ability of schools to compete for students and funds is strictly limited.

- Little has been done to upgrade standards of literacy and numeracy and restore rigour to the curriculum.

The Employment Contracts Act 1991 removed many arbitrary barriers which had prevented employers and employees from cooperating for their mutual benefit. It made it possible for remuneration to better reflect skill and led to a large increase in training. Through the Act's impact on unemployment, larger numbers of people have obtained the important benefits of on-the-job training. However, many unemployed people have failed to gain a foothold on the employment ladder because of the increases in the minimum wage and the job-destroying activities of the Employment Court.

Some people suggest that New Zealanders have cultural attitudes towards work and education that are not conducive to economic growth. The comments that Australia's Productivity Commission has made on the attitudes of Australians are interesting in this context. It stated in a recent report:

> It is not that Australians are inherently any more lazy, accident prone, sick on Mondays, militant in industrial relations, spendthrift, prone to welfare dependency or tax evasion than any other nationality. The point is that the rules in place have provided incentives for 'inefficient' behaviour and many people have responded accordingly.
>
> Australia's productivity performance has been handicapped by government policies and practices over many years that have weakened or distorted incentives to be cost-conscious, innovative and productive.[13]

There is no reason to think that Australians and New Zealanders have fundamental values that are less conducive to growth than people living in more successful countries. It is interesting to note that the people of some Asian countries, who now have a well-deserved reputation for industriousness, were considered by foreign visitors earlier this century to be idle and slothful.[14]

Profound changes in behaviour, including changes in the willingness of people to learn new skills and business practices, are required as people respond to a new policy environment. There is plenty of evidence that this has been occurring in New Zealand. Nevertheless, the OECD is correct to point out that:

> … it takes time for (deeply entrenched) economic behaviour to change and for both producers and consumers to adjust to a different set of policies and incentive structures. After all, although the reform programme was initiated in 1984, many of the key policies are still being implemented and, as such, have yet to have their full effects felt.[15]

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13 Productivity Commission, *Stocktake of Progress in Microeconomic Reform*, Canberra, 1996, p 24.

14 See, for example, the quote from an Australian consultant visiting an Asian country in 1915 in Anderson, *op cit*, p 3 (see footnote 10).

15 *Loc cit*.

Growth potential

I hope I have said enough to make the case that New Zealand is not necessarily doomed to be a low-growth economy. But is it capable of becoming a high-growth one?

What do we mean by a high-growth economy? A small number of countries have had average per capita growth rates higher than 5 percent since 1960. However, they all started from a low base. The adoption of growth-oriented policies tends to result in faster growth rates in poorer countries. Typically they can shift employment away from agricultural activities and adopt technologies and practices that have been successful in other countries.

It would be reasonable to regard New Zealand as a high-growth economy if it could sustain per capita income growth of 4 percent per annum – which corresponds to a GDP growth rate of about 5 percent. In a report *Moving into the Fast Lane,* which the New Zealand Business Roundtable published in association with the Auckland and Wellington chambers of commerce in 1996, we defined the 'fast lane' as per capita income growth of 4 percent per annum. We argued that this would require continuing policy reforms to encourage an expansion of the resource base (including human and physical capital) and more productive use of resources.

New Zealand's per capita income growth would need to be at least 3 percent (GDP growth 4 percent) to close the gap between its average income level and that of the United States at the typical rate of convergence for other countries. Growth researchers have found that where the conditions necessary for income convergence have been met, the gap between incomes in rich and poor countries (or between rich and poor states within a country) typically vanishes at the rate of about 2 percent a year. This is a big ask, but there is nothing to stop New Zealand matching US income levels; last century our per capita incomes actually exceeded those in the United States.

Policies for the fast lane

What policy changes would be required for New Zealand to move into the fast lane? Post-1993 governments encouraged the view that all the hard work had been done and no new challenges needed to be faced, including those of an aging population. This view is no more valid today than it was three years ago when the immediate prospects looked much brighter. In a speech I gave in June 1995 I made the point that "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' ". I made a guess that the reforms had lifted New Zealand's long-term growth rate to about 3 percent per annum – which is consistent with the OECD's recent assessment.

There is also a view that the Reserve Bank's exclusive focus on low inflation has involved a cost to economic growth. However, the Reserve Bank has been correct to argue that the best contribution that monetary policy can make to growth is to keep the general price level stable.[16] In an inflation-free environment, investors and the public have the best chance of correctly reading market signals – working out which goods and services represent best value, where best returns on investment may be found, how much to consume and how much to save.

National Party ministers used to talk about achieving 3.5–5 percent growth in the period to 2010, but they seem to have given up on any such ambition. In *Moving into the Fast Lane* we listed a range of reforms that could achieve such a target. When I revisit this list I am left in no doubt as to why New Zealand is not showing any signs of doing so.

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16 Donald Brash, 'How fast can the New Zealand economy grow?', address to the Auckland Rotary Club, October 1997.

The first point we made was that central and local governments must limit their activities to their proper roles in the economy. Little progress has been made here. They are still both heavily involved in a range of activities that they do not undertake efficiently.

Second, we said that government spending should be reduced to around 20 percent of GDP or below by 2005 by a combination of expenditure restraint and reductions and the adoption of policies to promote faster economic growth. As a result of the huge increases in spending since 1993, the government's much more modest target of reducing its expenditure to 30 percent of GDP (which was supposed to have been reached this year) has now been pushed out to 2006/2007.

Third, we said that the privatisation programme needed to be revitalised. It would be an exaggeration to describe recent moves in this area – welcome though they are – as regaining momentum. Many countries, including Australia, have been moving at a much faster pace.

Fourth, we said that regulatory burdens should be reduced. Progress in this area has been very slow. Tariffs are being removed on an extended timetable, the government appears to be backing off from producer board reform, nothing has been done to curb the obstacles to job creation being thrown up by the Employment Court, the Resource Management Act 1991 discourages investment, and we have seen moves away from lighthanded regulation in the electricity industry and threats of similar moves elsewhere.

Fifth, we said that the education and training system needed to be upgraded to raise New Zealand's skill base. I made the point earlier that this hasn't happened. New Zealand has also lost enormous ground on immigration, which the recent changes in policy may be insufficient or slow to win back. Indeed lately we have seen a renewed population outflow – probably the most tangible indicator of all that the country has lost its way.

Overall, recent policy performance gives little reason for hope that New Zealand will soon regain the status of a high achiever that it attained in the mid-1990s. The government has been unwilling to acknowledge the drift and mistakes of recent years, and it is not explaining to the community why action is needed to cope with international economic instability and to restore growth. Recent initiatives have been erratic; they do not add up to a coherent medium-term strategy. The Mixed Member Proportional electoral system (MMP) has made the paralysis worse.

Outside the business community, there are few voices promoting a more ambitious vision. Those that are heard are typically not promoting policies for wealth creation – the only strategy that will raise incomes and solve social problems in the long run. Instead they are demanding more government expenditure and income redistribution, which would exacerbate the present difficulties. Australian voters have just rejected a return to failed policies of this kind and opted for continuing economic reform. Australia is no stand-out benchmark, and continues to perform well below its potential, but its outlook now looks decidedly better than New Zealand's, contrary to the position a few years ago.

So Alan Gibbs could be right in suggesting that New Zealand is doomed to be a lacklustre economy, but not because it does not have the potential to do much better. As I have argued, New Zealand does not suffer from any major natural handicaps that prevent it from becoming a dynamic place to do business. Indeed I suggest it has a number of assets, and there are others I have not mentioned including the British common law tradition – if only our courts would uphold it – and the English language which is the language of international commerce. But New Zealand has to make the most of these assets, and a small, remote country does need to stand out from the pack if it is to create interest in larger centres and attract capital and talent.

What will make the difference between the country's potential and what we actually achieve is the way we run our own affairs. Policy choices matter: they account overwhelmingly for the differences between the world's leading economies and the under-achieving economies. It is a matter of choice for New Zealanders as to whether we become a high productivity, high employment and high income country or whether we settle for mediocrity. If we opt for mediocrity, we should recognise, as Shakespeare put it, that:

> The fault, dear Brutus, is not in our stars,
>
> But in ourselves, that we are underlings.

THE PUBLIC SECTOR

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE 1999 BUDGET POLICY STATEMENT

FEBRUARY 1999

1999 BUDGET POLICY STATEMENT

Executive Summary

- Starting with its submission in 1995 on the first Budget Policy Statement (BPS) issued under the Fiscal Responsibility Act 1994, the New Zealand Business Roundtable (NZBR) has expressed increasing concerns about trends in fiscal policy. These have run counter to the improvements in fiscal discipline achieved during the 1990–1993 parliamentary term, which were a major factor in the strong economic recovery of the mid-1990s, and to the intentions of the Fiscal Responsibility Act 1994.

- In the NZBR's view the Coalition government's 1997 and 1998 budgets were risky to the point of imprudence. The Asian crisis has merely served to expose dramatically the underlying weaknesses in fiscal and growth strategies adopted during the last and current parliamentary terms. The present weak and unbalanced state of the New Zealand economy (with a large current account deficit) owes much to inadequate fiscal discipline.

- We believe that the 1999 BPS represents an inadequate response to New Zealand's problems and thereby compounds the earlier errors. This is in spite of our longstanding and very public support for many of the government's specific growth-enhancing objectives and proposals.

- In our view the government's strategy for economic growth is inconsistent with its growth objectives (see Section 2 of this submission). The strategy is too narrowly conceived, too many policies are being pursued that conflict with growth objectives, and too little is being achieved in important areas that would contribute to growth. Partly as a result of its failure to admit to underlying problems in a timely manner, the government also has major communication problems with its growth and fiscal strategies. Some important statements in the BPS simply lack credibility.

- We argue in this submission that much greater emphasis is needed on cutting government expenditure and taxes, and on privatisation and deregulation (particularly of the labour market) if New Zealanders' living standards are not to continue to fall relative to those in comparable countries.

- The BPS fails to consider an alternative medium-term strategy of vigorous government expenditure and tax cuts, reverting instead to a discussion of short-term fiscal stabilisers that appears to have no relevance to the issue of economic growth. In our view the fiscal strategy in the BPS is little more than a strategy of 'spend and hope'. It does not appear to be informed by an awareness of a growing amount of empirical research into the negative relationship between the size of government and economic performance (see Sections 1 and 3 of this submission).

- This submission also argues that the government's long-term objective of reducing expenses below 30 percent of gross domestic product (GDP) is both too modest and no longer credible. The government's short-term intentions for government spending are at odds with its long-term targets, and the 'spend and hope' fiscal strategy fails to reconcile the difference satisfactorily, contrary to the requirements of the Fiscal Responsibility Act 1994. We urge the Select Committee to express a clear view on this issue.

1 Introduction

1.1 This submission on the 9 December 1998 Budget Policy Statement (BPS) is made by the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand business firms. The purpose of the NZBR is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 This is the fifth BPS issued under the Fiscal Responsibility Act 1994 (the Act). In our submissions on the first two BPSs, we expressed our support for the Act and for the government's intentions at the time to use increased revenue from economic growth first and foremost to generate operating surpluses, reduce debt, build net worth and reduce taxes. As successive budgets have used a substantial part of the increased revenues to fund additional spending (see the Non-Finance Operating Expenditure Creep chart on page 52) we have become increasingly concerned about the impact of fiscal policy on the economy.

1.3 Since 1995 we have criticised the growth in government expenditure and expressed the view that real expenditure reductions would better serve the government's economic growth and social cohesion objectives. In our view, major reductions in government expenditure and much-reduced government regulation are essential both for the sustainable achievement of the government's objectives and to avoid seeing New Zealand's standard of living fall further below its potential and the levels achieved by comparable countries.

1.4 The NZBR's submissions on earlier BPSs documented the growing empirical evidence of an adverse relationship between the size of government and economic performance. We have argued that the government would better meet its growth objectives if government spending were progressively reduced to below 20 percent of gross domestic product (GDP) (the precise figure depends on the quality of the spending, not the percentage of GDP).

1.5 Section 2 of this submission discusses the inconsistency between the government's growth strategy as outlined in the BPS and its objectives for economic growth. Section 3 critically examines the BPS's fiscal strategy. Section 4 discusses the issue of the consistency of the BPS with the Fiscal Responsibility Act 1994.

2 The government's economic strategy

2.1 The Summary of the BPS maintains that the government has a comprehensive strategy for economic growth. It also asserts that during the last eight years it has "made substantial progress" towards the goal of creating "an environment that generates income and employment and promotes trade and social opportunities in which all New Zealanders can participate". In our view this is a claim that the 1990–1993 National government could fairly have made. However, substantial slippage occurred during the 1993–1996 National administration[1] and, notwithstanding some important initiatives, the overall fiscal strategy pursued by the 1996–98 Coalition government and the current National minority government has been highly negative for growth and employment. In this section, we look first at the growth record and then at the government's "comprehensive strategy for economic growth".

2.2 The BPS is based on the economic projections in the 9 December 1998 Economic and Fiscal Update. These confirm the pattern of recent updates – a lowering of growth expectations, a weaker fiscal position and a worse outlook for unemployment.

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1 Government expenditure increased markedly during this period, and by 1996 business and consumer confidence had fallen and growth was slowing. The sharp fall in unemployment has been reversed, partly due to court decisions that have re-regulated the labour market to a significant extent.

2.3 Based on these projections and actual growth to date, real GDP is expected to grow by a mere 3 percent during the government's 1996–1999 term of office. This would be a deplorable performance. When the government took office in 1996 it projected that the economy would grow by more than 10 percent in this period. The government's performance should also be measured against the National government's 1995 target range for annual economic growth of 3.5–5 percent to the year 2010. Given the under-performance to date, the growth rate for the remainder of this period would need to be 4–6 percent per annum in order for National to achieve its target. Even assuming an upturn in Asian and world economic growth after 1999, the latest economic projections do not envisage that New Zealand will achieve even the bottom end of this range before 2001/2002. Moreover, Annex 3 of the BPS discloses that the central scenario is based on average growth of just 3 percent per annum beyond this period, with the low-growth scenario being only 2 percent per annum. There is no indication of any action that National intends to take to raise the rate of growth to its target range.

2.4 In telling contrast, GDP in Australia grew by 5 percent in the year to September 1998 alone, despite that country's greater exposure to Asia than New Zealand's. Australia's medium-term outlook is now better than New Zealand's, contrary to the position a few years ago. Clearly New Zealand cannot primarily blame economic turmoil in Asia for the woeful growth record of recent years. In public policy terms, Australia has moved ahead of New Zealand in a growing number of areas, and it is continuing to show more momentum in this respect. Recently, for example, the federal government announced that small businesses would not be subject to regulations governing unjustified dismissals, a reform that, while much too limited, is not even being talked about by the government in New Zealand. Extensive privatisation is being implemented or promoted in Australia by federal and state governments of varying political persuasions.

2.5 The New Zealand government's strategy for economic growth does not look credible in the light of the gap between its growth objectives and actual and expected outcomes. Useful growth-enhancing measures, such as the elimination of tariffs (albeit on an extended timetable) and the limited introduction of competition in accident compensation, have been offset by negative factors. These include increasing social and economic regulation, increased regulation of the labour market by the courts and under the Human Rights Act 1993 (eg the 1999 discrimination provisions), the undermining of the rule of law (as evident in the electricity and Taranaki Maori land lease decisions) and the increasingly predatory approach to taxing productive activity. This last point is variously illustrated by the increases in government expenditure, the government's proposal to impose border charges on ports and airports and its decision to fund the Accident Compensation Corporation (ACC) tail by a particularly distortionary payroll tax (we submit that this decision should be reversed). Similar measures are being proposed by other political parties, eg the Labour/Alliance proposal to increase the top personal tax rate.

2.6 A fundamental problem is that the government's growth strategy continues to presume that big government is necessary and desirable. Many of the seven overarching goals and the eight strategic priorities in the BPS presume that the government can determine what outcomes diverse New Zealanders desire. They are highly dirigiste. A more credible growth strategy would put greater emphasis on providing institutional structures that allow people to better pursue outcomes of their own choosing.[2] The BPS places too much reliance on concepts derived from central planning.

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2 For example, the government could allow individuals much greater scope to determine how much of their own money they wish to spend on health and education, how much to spend on local heritage, and what aspects of New Zealand identity they value, while respecting the freedom of others to choose differently.

2.7 In our view, the essential elements of a more credible growth strategy would include:

(i) the pursuit of a more comprehensive set of growth-enhancing measures – notably free contracting in labour markets and much more vigorous privatisation;

(ii) much more action on – as opposed to talk about – deregulation, particularly in relation to the producer boards, the labour market including the professions, resource management, network industries, health and education and on a meaningful Regulatory Responsibility Act that reduces the cost of regulations on business activity;

(iii) a reversal of the current fiscal strategy in favour of a credible medium-term programme of expenditure and tax reductions (see Section 3);

(iv) much greater focus by the government on its core public good activities (which are not even mentioned in the BPS as overarching goals or strategic priorities), including respect for and enforcement of the rule of law and private property rights, and on approaches that would persuade foreigners that New Zealand is a desirable place in which to live and invest; [3] and

(v) much improved government communications concerning the need for ongoing adjustments in policy and business practices if New Zealand is to be a dynamic and competitive economy.

2.8 In respect of point (v), the government has failed to acknowledge the deficiencies in its growth strategy and the magnitude of the problems the country faces. The government's basic position has been to deny that weaknesses exist, as the extract from the BPS cited in paragraph 2.1 demonstrates. The Coalition government was slow to recognise the seriousness of the Asian situation and, when it did, its initial response was to deny that any adjustment in its spending programme was needed (implying that all the adjustment should be borne by the private sector). The government has now conceded that the situation is serious enough to warrant a slower rate of increase in expenditures, but the proposed adjustments are not material. The BPS continues to over-emphasise the role of uncontrollable factors such as the Asian crisis and the drought conditions that are prevailing in areas of New Zealand. It largely ignores the negative implications of the increased tax burden implicit in the major increases in government spending in recent years, and it puts far too much emphasis on ephemeral events to lift the economy – such as the pending Asia Pacific Economic Cooperation (APEC) conference. It is also arguably placing too much hope on forecasts that the Asian economies will recover quickly after 1999.

2.9 The government is still not acknowledging in the BPS the gap between growth outcomes and projections and its own growth objectives. The public cannot be expected to accept the need for policy adjustments to improve growth and living standards unless it understands that New Zealand's economic potential is not being achieved. It is hard to see how any growth strategy can be credible as long as the government remains in denial about its policy errors and the under-performance of the economy.

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3 The government's decisions in respect of electricity and Taranaki Maori land leases send a strong negative signal to all investors, as have statements at various times by influential politicians about Asian immigration, foreign investment and tax rates for society's most productive people. More rapid progress with reform of the international tax regime would be helpful here.

3 The government expenditure problem

3.1 In our view, the greatest single fiscal problem facing New Zealand is the rise in government expenditure. The Non-Finance Operating Expenditure Creep chart highlights the very limited nature of the recent spending reductions in relation to the overall trend. The most dramatic failure of fiscal control occurred in the election-year budget of 1996, but the upward trend was established in the budgets that followed the 1993 general election.

3.2 Government operating expenses are now projected to peak at 36.4 percent of GDP in 1999/2000, up from 34.3 percent in 1996/1997. This is a rise of 2.1 percent of GDP. Excluding finance costs, the rise is even greater – at 2.8 percent of GDP (from 31.1 percent to 33.9 percent). With the notable exception of Japan, New Zealand stands out amongst OECD countries for the sharp rise in government spending projected in the latest (December 1998) OECD *Economic Outlook* – in most other countries the ratio is expected to continue the declining trend of recent years or stay flat. The BPS projects operating revenues to hold at around 34.5 percent of GDP to 2001/2002. The net effect is that the operating balance is projected to be in deficit in each of the three years from 1998/1999 to 2000/2001. A further disturbing feature is that net debt is now rising again and is expected to peak at 27.8 percent of GDP in 2000/2001.

3.3 We acknowledge that the rise in government spending as a percentage of GDP compared with the 1998 budget arises primarily from downward reductions in forecast nominal GDP rather than a further rise in government expenditure. What has driven the forecast operating balance into deficit is a fall in forecast receipts as a result of lower nominal GDP. Our fundamental disagreement is with the government's premise of recent years that it is desirable to increase government expenditure as long as total spending is falling relative to GDP. The critical issues are the quality of all government spending and the tax burden it imposes on the productive sector of the economy.

3.4 When, as is the case in New Zealand, spending by all levels of government is around 40 percent of GDP, the quality of that spending is critical for standards of living. In our view, the quality of much central and local government spending is very poor. Governments have expanded far beyond their proper roles and levels of competence in many, if not most, areas. The NZBR has presented the government with specific spending reduction proposals on many occasions, for example in the 1996 report *Moving into the Fast Lane*. Page 19 of the BPS asserts that:

> The government will continue its rigorous examination of new and existing expenditure to ensure that money is spent only where justified.

This assertion is little short of astounding in the light of persistent demonstrations by the business sector of ways in which the government could cut unjustified spending. It can only serve to reinforce the feeling that the government long ago stopped listening to the business community about this aspect of its growth strategy.

3.5 Naturally, elected governments are free to put the interests of the beneficiaries of specific government expenditure programmes (including the public service itself) ahead of the goal of promoting greater economic growth to lift the living standards of New Zealanders at large. But they cannot then maintain that they have ambitious growth strategies, such as annual growth targets of 3.5–5 percent of GDP. Moreover, they cannot claim that such programmes are justified on equity grounds when, as is often the case, they are poorly targeted. For example, given the overarching goals in the BPS, how does the government justify taxing relatively well-off New Zealanders in order to buy health and education services for the same group? Overarching goal 4 expresses the sound view that high taxes should not be used to support high-income earning New Zealanders in respect of social assistance in welfare and housing. Why then does the government not apply the same principle to other government 'social spending'? For example, how does it justify not reversing the decision to provide New Zealand Superannuation on a universal basis, with the result that high-income superannuitants are now being supported by lower-income taxpayers? Many of the policies of the Coalition government had much more to do with the special interests of better-off constituents than with equity. They should be revisited as being inconsistent with the goals outlined in the BPS.

3.6 The credibility problem is further increased by the claim on page 7 of the BPS that the government's seven overarching goals "are independent and mutually reinforcing". Clearly, policies intended to redistribute wealth or to prevent change that some deem to be harmful to the environment, 'cultural identity' or biodiversity have the potential to conflict sharply with growth-oriented objectives. Denying the existence of such a trade-off is disingenuous.

3.7 It is also disappointing and revealing that there is no discussion in the BPS of the desirability of a medium-term strategy of cutting expenditure in order to cut taxes. The BPS, at the top of page 18, raises instead the issue of the "appropriate level of commitment and limit for *additional* policy spending" (emphasis added), thereby ignoring all private sector and taxpayer arguments for reductions in existing spending. Furthermore, the discussion of this issue is immediately diverted on to the topic of automatic fiscal stabilisers. The BPS concludes that:

> It would not be desirable for the government to fully counteract the automatic stabilisers by implementing further policies designed to correct the short-term fiscal imbalance. Doing so would risk exacerbating the weaker economic situation. The government's previous actions to reduce public debt mean that short-term action is not required to maintain credibility.

However, we are not aware of proposals for expenditure reductions "designed to correct the short-term fiscal imbalance". In our view what is required is a vigorous medium-term programme of expenditure and tax reductions. The idea that principled expenditure reductions could exacerbate the economic situation is a throwback to defunct Keynesian notions that have been discredited on many occasions in many countries. This passage represents a reversal of the thinking underlying the cuts announced in National's 1991 budget, which preceded a period of economic growth that was extraordinary by New Zealand and OECD standards. The current National government has made a 180-degree turn on fiscal strategy since 1991 – yet claims in the BPS that it has made substantial progress towards promoting economic growth *during the last eight years*. This inconsistency is startling and further erodes credibility.

3.8 A medium-term programme of reducing government spending to below 20 percent of GDP would enable a resumption of the programme of debt and tax reductions. The return to operating deficits has led to a rise in projected net and gross debt ratios, contrary to the government's stated intentions. Further divestment of government-owned businesses would also contribute to debt reductions. The two recent rounds of tax reductions (1996 and 1998) have benefited low- to middle-income earners in particular, but they have had the unfortunate effect of widening rather than flattening the income tax scale and hence making the tax system more complex. Also the deferment of the second round of tax reductions was unhelpful in terms of certainty of fiscal policy and the plans of firms and households. The highest income tax rates have the largest deadweight costs and are most harmful to growth. Priority should be given to lowering them in order to reduce the cost of capital to firms and the borrowing costs of households, encourage investment and reduce distortions caused by the progressive income tax scale. Given firm expenditure discipline, a medium-term programme of tax reductions should be set out in broad terms by the government.

4 Consistency with the Fiscal Responsibility Act 1994

4.1 Annex 2 of the BPS summarises the requirements of the Fiscal Responsibility Act 1994. It also tabulates the BPS's long-term and short-term objectives in relation to the principles set out in that Act. The Annex refers readers to the Fiscal Strategy section of the BPS for a discussion of the reasons for changes in short-term intentions and of the government's approach to achieving its longer-term objectives.

4.2 In our view the government's longer-term fiscal objectives are no longer credible in the light of its fiscal strategy for the next three years and the political uncertainties that lie ahead. A key feature of Budget Policy Statements since 1995 has been the objective to reduce operating expenses below 30 percent of GDP. Far from reducing expenses relative to GDP, the ratio will have risen for four successive years to 1999/2000 according to the projections in the BPS. Table 2 on page 22 of the BPS indicates that operating expenses will still be 31.1 percent of GDP in 2008/2009 – and the reduction to this level depends on the hoped-for economic upturn and constraint in the *growth* in government expenditure.[4]

4.3 Far from instituting a programme of withdrawing government from areas in which it has no comparative advantage, it is clear that the government's expenditure strategy is to increase total spending and to rely on economic growth to reduce the overall expenditure ratio. This makes the credibility of the government's fiscal policy depend on the credibility of its strategy for economic growth. But high spending and taxation burdens discourage economic growth, as New Zealand's experience in the 1970s and 1980s and again in recent years clearly demonstrates.

4.4 Currently a major force for increasing government expenditure is the open-ended nature of the government's objectives in many areas. Spending policies intended to improve outcomes in relation to health, education, housing, poverty, safety or the environment have no finite limit. Nor can any finite level of spending satisfy those who would benefit from yet more spending in any of these areas. The widespread community dissatisfaction with health and education services, despite large increases in outlays on them, illustrates this point. Where there is no principle for determining spending, arbitrary limits do not provide a robust constraint. A credible programme for reducing the size of government requires governments to redefine their role and eliminate open-ended spending programmes where possible. By focusing instead on 'improving' outcomes by additional expenditures, the BPS fails to meet this requirement.

4.5 To conclude, we consider the BPS fails to conform with the requirements of the Fiscal Responsibility Act 1994 to:

- assess the extent to which short-term intentions are consistent with the principles of responsible fiscal management and long-term objectives; and
- state the approach needed to become consistent and the period this is expected to take.

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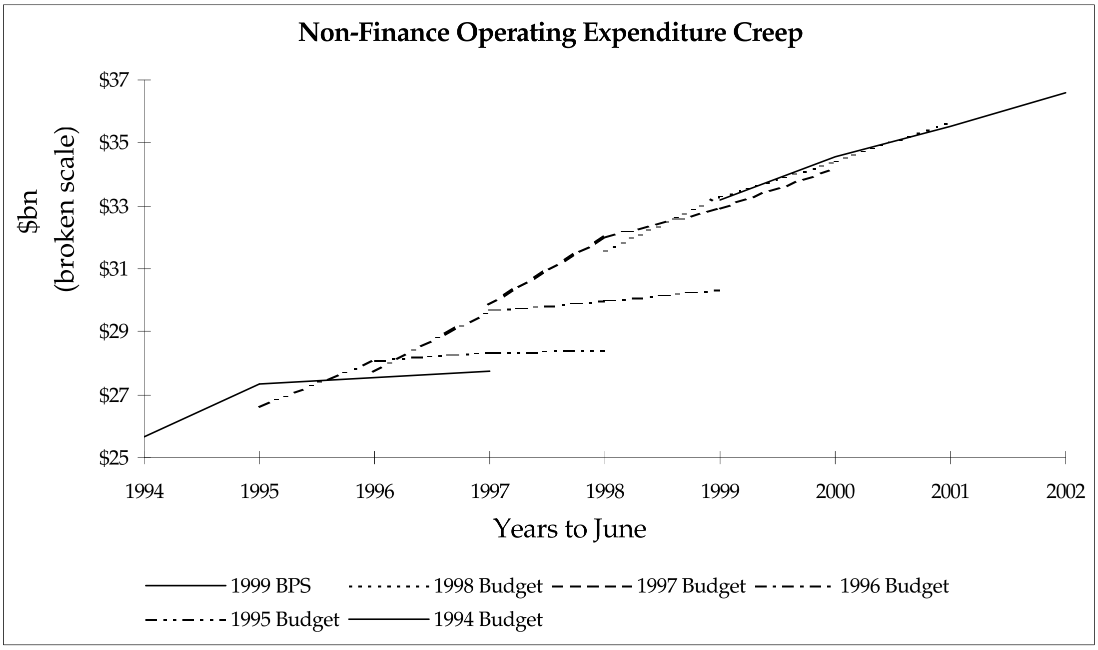
4 The government could have shown greater reductions in the ratio of expenses to GDP by dropping the technical assumption that allows for annual additional spending of $600 million (increased by inflation and "the real growth factor") beyond 2001/2002 (see page 33). We commend it for its integrity in thus disclosing its underlying expenditure strategy.

The Act was intended to provide a safeguard against 'spend and hope' fiscal strategies. It was not intended to enable governments to set long-term objectives and claim conformity with the Act merely through successive postponements of the target date for meeting them. The Act intended that governments would take concrete action to remedy departures from sound fiscal plans.

4.6 Given its fiscal discipline in preceding years and fiscal trends at the time, the National government's 1995 BPS projection of achieving its long-term expenditure objective by 1997/1998 (a figure of 30.5 percent of GDP for that year was projected) was credible. The intention in the 1999 BPS is effectively to defer the achievement of that objective by more than a further 10 years. Given this absurdly extended timetable, the government's demonstrated lack of fiscal discipline in recent years, the fact that the ratio is rising not falling, and the absence of proposed policy responses to the departure from the target, we consider that the government's fiscal strategy is not credible or consistent with the intention of the Fiscal Responsibility Act 1994. In the case of the objective for net debt, which the government reduced to 15 percent of GDP in 1997, the BPS reveals a sharp increase in earlier projections to almost twice that level. In the absence of proposed remedial action, we consider this trend is also not consistent with the intentions of the Act. Accordingly we ask the Select Committee to state clearly its view on whether the BPS complies with these aspects of the Act and, if not, what the government is required to do to conform with it.



NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON COST RECOVERY OF PASSENGER AND CRAFT BORDER CLEARANCE SERVICES

NOVEMBER 1998

SUBMISSION ON COST RECOVERY OF PASSENGER AND CRAFT BORDER CLEARANCE SERVICES

Summary and Conclusions

- This submission on the September 1998 inter-departmental discussion document *Cost Recovery of Border Clearance Services for Passengers and Craft* 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 NZBR fully supports a policy of user charges for government-provided goods and services where purchases are voluntary, supply is subject to competition and the government chooses not to privatise the government provider. As long as supply is on a competitively neutral basis, such user charges can be thought of as a price that tracks marginal cost and reflects marginal user valuations.

- However, where the government-owned supplier is a statutory monopoly, there is no competitive discipline on the cost of supply. Government ownership will also weaken, if not eliminate, the incentive to minimise costs. The combination of the absence of competitive disciplines and the bureaucratic incentives to expand activities reduces the efficiency gains that might otherwise be obtainable from user charges. In particular, there is a risk that services will be inferior and excessively costly. Credible checks and balances on any user charges are required in order to prevent the abuse of a dominant position.

- In the case of public goods, users who do not pay any charge can, by definition, still benefit from the service. Publicly provided public goods must be funded by mandatory charges or taxes. These may be set at levels that fail to reflect either supply cost or user valuations of benefit. Any taxes should be evaluated in terms of their conformity with sound tax policy principles.

- In the case of so-called 'club' goods, people who do not pay an access fee can be excluded from the benefits offered by the facility, but once access is obtained the marginal cost of use may be low or even zero. Club goods are therefore an intermediate case between a private and a public good. The optimal funding of private, club and public goods is discussed in Section 2.

- Border protection services are a public good. The policing of laws and regulations is a public good activity, the benefits of which accrue generally. Fines imposed on wrong-doers help fund enforcement costs. Where the provision of a public good benefits the population as a whole, remaining financial requirements should be funded from general taxation. Indeed, as noted in Section 2, the proposed mandatory charges have the characteristic of a tax rather than a price. Taxes tend to be characterised by compulsion and by the absence of any close link between benefit and impost.

- Section 3 addresses the 'source of risk' and 'avoidable cost' arguments to the effect that the proposed charges are a user fee and not a tax because border protection services allegedly benefit travellers and importers rather than pest-sensitive industries or the public at large. The discussion concludes that these propositions provide no stable or reliable basis for public policy. Both depend on arbitrary assignments of liability and neither demonstrates that the cost of border protection services represents the optimal charge in relation to any given assignment of risk.

- The discussion concludes that the assignment of liability in respect of the regulation of risk, and the payment of any compensation for any takings of property rights in making such an assignment, are separate from the issue of the subsequent optimal enforcement of property rights.

- Providers of tourism services and of sea and airport facilities do not benefit more than the public at large from an extra dollar spent on policing the borders. Nor do they have any superior information about the marginal benefits that accrue to pest-vulnerable industries as a result of an extra dollar spent on border protection.

- The fact of compulsion and the absence of a link between benefit and the quantum of payment justify the conclusion that the proposed border charges are a tax and not a price. Section 4 considers the optimality of the charges in terms of sound tax principles concerning constitutionality, equity, efficiency and conformity with due process.

- On the constitutionality aspect, the submission notes legal views that the proposed charges may conflict with New Zealand's obligations under international law. We are also concerned in this context that, as a matter of principle, adequate safeguards must be put in place when the power to tax is delegated. We do not believe that this is currently the case.

- From an equity perspective, we note that the tax appears to be highly discriminatory. This is because those liable for the tax do not receive any service that they can be expected to value more than any other law-abiding citizen. It is a gross misnomer to call this tax a *user* charge. Nor can the proposed charges be thought of as a penalty for illegal behaviour. The majority of those who are liable for the proposed charges are unlikely to be in breach of any law. Injunctions, fines, imprisonment or tort actions provide more appropriate sanctions for those who might or do breach the law.

- On the efficiency aspect, the submission rejects the claim that the proposed charges represent an efficient way of harnessing any information sea and airports have about the performance of border protection activities. To the contrary, we concur with the view that the proposals invite bureaucratic expansion and excessive border protection costs. There is a risk that they could increase bureaucratic tendencies to adopt a high cost, low risk enforcement strategy.

- Although it is an empirical matter, the NZBR shares the concerns of some in the travel industry that would-be foreign visitors and exporters could respond quite significantly to attempts to shift the burden of New Zealand taxes on to foreigners. Propositions that there is a 'free lunch' in taxing foreigners need to be closely argued rather than loosely asserted.

- Another efficiency concern is that the proposed charges have the character of a tied tax. Tied taxes can lead to excessive spending on the activity to which revenues are tied.

- Finally, in respect of conformity with sound tax policy processes, the proposed charges do not appear to accord with the requirements of the Generic Tax Policy Process. In particular, this sets out procedures that should be followed prior to the enactment of tax legislation and for systematic review after it has been passed. The date for this review must be set prior to the adoption of legislation by parliament. Given the controversial nature of the propositions about elasticity of response and industry complaints about the level of charges, such a provision is highly desirable.

- In short, the proposed charges appear to be deficient from a tax policy perspective in all major respects. The proposal to recover 100 percent of border protection costs from a target group which obviously does not benefit can only indicate that the policy framework is seriously deficient. There appears to be no sound grounds for departing from a policy of sensibly scaled fines for transgressors and taxpayer funding of a level of enforcement of border laws that parliament deems to be optimal.

- In the NZBR's view, the current proposals indicate that the government does not have a sound policy framework for addressing user charge issues in the context of mandatory services of a public good nature supplied by a statutory monopoly. The proposals should be put on hold until the current framework is thoroughly reviewed.

1 Introduction

1.1 This submission on the September 1998 inter-departmental discussion document *Cost Recovery of Border Clearance Services for Passengers and Craft* is made by the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand business firms.[1] The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 In recent years, public policy has arguably failed to distinguish adequately between desirable user charges and undesirable discriminatory taxation. Reflecting these concerns, the NZBR and the New Zealand Food and Beverage Exporters' Council commissioned Credit Suisse First Boston to prepare a report on these issues in 1997. Credit Suisse First Boston's (CSFB's) July 1998 report, *Regulation of the Food and Beverage Industry*, discussed many of the analytical issues involved in user charges. This submission applies the framework developed in that report to the funding of border protection costs.

1.3 The NZBR supports strongly user charges that are likely to improve economic efficiency. User charges that track marginal cost and reflect user valuations have desirable efficiency attributes. They are likely to be most efficacious in this respect when supply is competitive, purchasing is voluntary and the commodity being supplied has the characteristic of a private good.

1.4 However, when user charges are mandatory and do not closely reflect user valuations, they take on the characteristic of a tax rather than a market clearing price. The case for viewing a proposed mandatory user fee as a tax is heightened when the good or service is a public good and is being provided by a statutory monopoly. So-called 'club' goods are an intermediate case. Section 2 discusses the optimal funding of private, club and public goods. It also argues that many border protection services have the attributes of a public good.

1.5 Disputes, if not confusion, over who benefits from a government-supplied service have been a feature of debates over user charge policies. A regulation may aim to stop one group or activity from harming another group or activity, or from putting that second group or activity at risk. Who benefits from that regulation? One view is that the regulation benefits the group or activity that would otherwise be put at risk. The counter-view is that a regulation effectively permits members of the first group to go about their affairs to a degree that would not be permissible but for the existence of the regulation. Government agencies that are under pressure to impose 'user charges' and that are keen to maintain their scale of operations will naturally propose to recover their costs from the most administratively and politically convenient group or activity. They may seek to justify their proposal against the criticism that it is a discriminatory and unwarranted tax by opportunistically citing whichever of these contesting views best supports the case for a user fee. Clearly there is a need for a principled and consistent approach to the question of whether the application and quantum of any user charge reflects the benefits derived from those on whom the cost is imposed. This issue is discussed in Section 3.

1.6 Section 4 discusses the issue of how to assess user fees that are best described as taxes. The merits of any proposed taxes should be assessed in terms of their constitutionality, equity and consistency with optimal tax (efficiency) principles.

1.7 For convenience, the Appendix lists five arguments that have been put forward for recovering costs *via* the proposed discriminatory charges, indicates the sections of

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1 *Cost Recovery of Border Clearance Services for Passengers and Craft*, September 1998, Discussion Document, Ministry of Agriculture and Forestry, New Zealand Customs Service and New Zealand Immigration Service, pp 1–47.

this submission in which four have been addressed, and briefly comments on the fifth argument.

2 User charges for publicly provided private, club and public goods

Definitions and concepts

2.1 User fees have potentially a useful role to play in promoting efficient resource use by confronting users with the costs that their demands would impose at the margin on society. The efficiency of a user charge to recover costs depends on whether it is the most efficient way of inducing the production of the socially optimal amount of the underlying good or service.[2] As defined, a user fee is a price that might aim either to recover a user-induced cost of supply or to correct a market failure. It is the former aspect that is relevant to the border protection proposal discussed in this section.

2.2 The *MIT Dictionary of Modern Economics*[3] explains that the price of a good or input signals what has to be given up in order to obtain that good or service. From a societal point of view, what has to be given up if that good or input is supplied is the opportunity cost of the supply of that good or input.

2.3 Charges that track the marginal cost of supply force fee-paying users to consider at the margin whether the benefit they hope to derive is commensurate with this cost of supply. As long as potential purchasers can avoid the charge by going without, the user charge deters a welfare-reducing supply if the prospective purchaser deems the benefit from the service to be less than the costs of supply. In this environment, user fees are a price and can be interpreted as reflecting a balance between marginal benefit and marginal cost.

2.4 Fundamental to this case that user charges improve efficiency are the assumptions that:

- the commodity being sold is a private good;
- purchase is voluntary;
- competition creates pressures to supply at minimum cost;
- price reflects the marginal benefit to the purchaser and to society; and
- price reflects the opportunity cost of supply – eg social marginal cost.[4]

2.5 However, as a matter of best practice, private goods should be supplied privately and competitively. User charges only have a useful potential role to play where a government agency provides the private good nonetheless. Where a Crown-owned entity is supplying private goods it should be exposed to competition from private providers and, to the greatest feasible extent, full commercial disciplines in respect of pricing, cost control and cost recovery. There is no case for making the purchase of a private good mandatory.

2.6 A public good is the opposite of a private good. In its strictest form, there is no way of charging those who benefit from a public good because it is too costly to exclude

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2 See p 801 in 'Federal User Fees: A Legal and Economic Analysis', Clayton Gillette and Thomas Hopkins, *Boston University Law Review*, Vol 67:795, pp 795–874, 1987.

3 *MIT Dictionary of Modern Economics*, 4th edition, David W Pearce (ed), MIT Press, Cambridge, Massachusetts, p 340.

4 But note that privatising supply is likely to be superior to the imposition of a user-pays policy in such cases.

those who benefit but do not pay.[5] Virtually by definition, the funding of publicly provided public goods is a tax issue.

2.7 Gillette and Hopkins[6] distinguish usefully between a user charge and a tax as follows:

> A user fee is a price charged by a governmental agency for a service or product whose distribution it controls. A user fee is, at least in theory, a benefit-based source of revenue whose logic is simple. Payment of a user fee reflects receipt of a valued service … . By contrast, federal income taxation is generally not benefit-based: rather, it imposes burdens that reflect complex Congressional judgments about, among other things, a taxpayer's ability to pay.

2.8 In similar vein, the New Zealand Institute of Economic Research's (NZIER's) August 1998 report for the Ministry of Agriculture and Forestry on cost recovery issues defined a tax as:

> … compulsory unrequited payments to government – unrequited meaning that the benefits are not normally in proportion to benefits.[7]

Based on such definitions,[8] taxes are associated with compulsion and the inability to relate the size of the impost to the magnitude of the benefit received by the person liable to pay the tax. Conversely, user fees are characterised by being discernibly related to the value to the payer, or the cost of supply, where the payer is the beneficiary and can choose whether or not to 'buy' and so incur the charge. (Part costs apply where only part of the benefit accrues to the payers.)

2.9 Club goods are an intermediate case. Unlike the case of a public good, with a club good those who do not pay for access to the club's facilities can be excluded. Motorised use of the public roads is a case in point. However, as long as there is excess capacity, a club good may share the public good characteristic that the use of its facilities by any one member does not detract from the ability of any other member simultaneously to enjoy those facilities. Uncongested golf courses, cinemas and roads are examples of club goods.

2.10 The public provision of a club good permits, again by definition, the possibility of charging those who wish to benefit from the service. The CSFB report finds that it is desirable to charge those using such services directly:

> … since the annual access or membership charge is part of the test that members are prepared to fund the total cost of the activity.

However, the case for charging members of any group or club the opportunity cost of the facilities provided is stronger the greater their ability to determine the level of service and the amount of the charge.

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5 In many cases, public goods can be provided privately because they can be funded by charging commensurately more for bundled private goods. Thus supermarkets do not charge their customers directly for the use of supermarket carparks.

6 Gillette and Hopkins *op cit*, p 800 (see footnote 2).

7 See NZIER, *Cost Recovery of Passenger and Craft Border Clearance Services: An Economic Analysis of Funding Options*, report to the Ministry of Agriculture and Forestry by Mary Clarke with assistance from Stephen Gale, August 1998, p 1.

8 E M Middlemass, *Government Charges: A Study of Charging for Goods and Services in the New Zealand Public Service*, September 1991, pp 1–68, cites, at paragraph 5.2, a 1985 judgment by the High Court of Australia to similar effect.

2.11 Road-user charges, petrol taxes and motor vehicle licence fees suffice currently to fund more than fully the cash expenditures of the suppliers of road infrastructure services. It is not compulsory to buy a vehicle that is subject to petrol tax or road-user charges. There is therefore a valid efficiency argument for confronting such road users with charges that reflect use-related costs of supply. (These include the costs of increasing future capacity and justifiable maintenance of existing roads.) However, as the experience with petrol tax in particular indicates, the actual charges imposed when there is a statutory monopoly may have a general revenue element. Optimal tax issues can arise even when purchase is not mandatory.

2.12 The hoped-for efficiency gains are likely to be reduced, and may disappear entirely, if the charge is mandatory or does not track marginal cost efficiently. Confidence that user charges will track costs appropriately is greatest when supply is competitive, the commodity is a private good and purchasing is voluntary. The less competitive supply conditions are, the less confidence there can be that user fees will track marginal cost optimally.

2.13 On the supply side, the relationship between user fees and marginal cost may be especially problematic when the supplier is a statutory monopoly. Charges could be too low where users have been able to achieve undue political influence over the fee-setting process. Conversely, charges could be too high in any one of three distinct cases. First, a profit-maximising statutory monopoly might set price to equal marginal revenue, not marginal cost. Second, a regulated statutory monopoly or industry (whether or not it is government-owned) may operate in a cost-plus manner, so that user fees are too high because costs are too high. Third, a government may set user charges above the costs of supply for general revenue purposes – as appears to be the case in respect of fuel excise duties.

Application to border protection services

2.14 The provision of border protection services is clearly a public good. Those who benefit from the government keeping out undesirable aliens, pests or diseases cannot be excluded from the benefits should they refuse to contribute to the costs of border protection. Nor does the benefit they derive detract from the benefits derivable by others. Unlike the case of those who want to drive on the roads, those who wish to benefit from border protection services do not need to join a 'club' in order to benefit – except the club comprising all residents of New Zealand and perhaps many investors in New Zealand. This is the *prima facie* case for funding the costs of border protection from general taxation.

2.15 A property right enforcement perspective supports the proposition that the provision of border protection services is a public good that should be funded from general taxation. Government border protection rules essentially define citizens' property rights in relation to undesirable non-residents and the importation of unwanted pests and diseases. The enforcement of property rights is a crucial obligation of good government. All citizens and investors in New Zealand benefit from well-enforced property rights and none can be excluded from these benefits.

2.16 The proposed border charges have the following features:

- payment is compulsory;
- those who pay, and their customers, do not receive a service they desire;
- the virtue of the price mechanism for revealing user valuations of the benefits of more or less enforcement is absent;
- supply is a statutory monopoly;

- there is no competition to create pressures to minimise costs; and
- the policy of 100 percent cost recovery requires arbitrary allocations of common costs. These violate efficient pricing principles and the concept of marginal cost.

2.17 Given these features, the proposed border charges raise concerns on both the supply and demand sides. The features suggest strongly that the proposed charges are a tax rather than a price. Those who would still defend them as a price must make the case that people entering New Zealand, or bringing goods into New Zealand, receive a benefit from border protection services that is commensurate with their cost. This issue is discussed further in Section 3.

3 Who benefits from border protection services?

3.1 As argued in Section 2, the basic enforcement of existing property rights, laws and regulations is a public good. The benefits are widely dispersed and accrue to some degree to all law-abiding citizens.

3.2 Where a new law or regulation constrains someone's existing property rights or personal freedom in order to benefit another group, it is possible to say that the second group is a beneficiary of the new law or regulation. In these circumstances there may be a case for requiring the beneficiaries to compensate the first group for the taking. However, such 'one-off' benefits derived from a new law or regulation are different from the benefits derived from the subsequent policing of the law or regulation. There is no reason to believe that the amount of one-off compensation payable by the beneficiaries of regulation, or of legislation, on its enactment should be closely related to the subsequent amounts the authorities wish to spend on policing the new laws or regulations.

3.3 Once the new law or regulation is in place and the compensation issue has been decided, it is for the government to determine the optimal level of enforcement of its laws or regulations from a public good (law and order) perspective. Individuals or groups can top-up the publicly provided level of security with their own security measures.

Source of risk

3.4 The 'source of risk' argument, that the costs of enforcing property rights should fall on an activity that is a source of risk for another activity, simply begs two questions. The first is why the costs of enforcing property rights should be regarded as the correct amount to charge the risk-creating activity if the goal is to reduce the level of risk to an optimal level. That cost is not closely related to the potential losses from undesired visitors, pests or diseases. The second question is why the pest-vulnerable activities should be given a preferred status in respect of the apportionment of policing costs. The alternative would be to regard those investing in vulnerable activities as reducing the potential benefits to the community from freer international travel and trade. Under this view ports should be paid for costs incurred in serving the interests of pest-vulnerable activities and the general public interest.

3.5 It is important to note that law-abiding visitors and importers are not sources of risk if they observe New Zealand's laws in respect of border protection. (Of course, it is appropriate to fund the costs of border protection in part from fines on those who fail to observe New Zealand's laws.)

3.6 In general, law-abiding citizens are not liable for the costs of lawfully exercising any rights they enjoy because others might seize the opportunity created by an activity to break the law. Thus freedom of assembly and speech are protected. Similarly, the Rugby Union and the promoters of rock concerts are not charged for the level of policing the New Zealand Police chooses to provide in its role of protecting law and order.

3.7 In short, the sources of risk argument is fundamentally incompatible with the exercise of freedom of assembly, freedom of speech, and the legal exercise of property rights.

Avoidable costs

3.8 The 'avoidable cost' doctrine seeks to recover from an industry the costs of policing an industry's activities that would be avoided if the industry did not exist. This argument was discussed critically and extensively in the CSFB report, particularly in the chapters discussing cost recovery in respect of biosecurity and fisheries.

3.9 As applied in the case of fisheries and ports, the argument appears to be based on the view that the government would not be incurring the costs of policing the seas and ports if commercial fishing, travel or importing activities did not exist. It appears to imply that everything can be prohibited or banned without cost unless those wishing to exercise their property rights or freedom to travel pay an impost to the government of the government's choosing. According to this view, the benefit derived from the payment of the fee is the freedom to enjoy whatever remaining property rights and liberties are left to the individuals concerned.

3.10 The proposition that a developer benefits from the costs incurred in ensuring that a proposed development satisfies objections raised by planners, competitors, environmentalists and other parties representing opposing interests seems to be similar in kind to the avoidable cost proposition. According to Gillette and Hopkins, for many years the Food and Drug Administration in the United States staunchly resisted pressure from the Office of Management and Budget to impose user charges on applicants for new drug approvals. Its opposition was based in part on the grounds that these activities were designed to protect the general public from impure or ineffective products.[9] However it has since dramatically reversed its position and now reportedly takes the view that:

> … any activity – and review of applications for new drug approvals in particular – performed in order to permit a regulatee to satisfy statutory prerequisites constitutes a sufficient benefit to permit imposition of a user fee … .[10]

Gillette and Hopkins report that this view is consistent with the dominant definition of benefit throughout federal agencies.

3.11 Clearly, like the sources of risk approach, the avoidable cost proposition denies the sort of rights that are embodied in the Bill of Rights Act 1990.[11] We are also aware of a case that the proposed border charges might breach New Zealand's obligations under international law.[12] A government that takes the view that it has the unfettered right to close down an activity or prohibit overseas travel without

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9 Gillette and Hopkins *op cit*, pp 851–853 (see footnote 2).

10 Gillette and Hopkins *op cit*, p 852 (see footnote 2).

11 Travel Industry Coalition, *Submission to the Social Services Select Committee on the Immigration Amendment Bill 1998*, November 1998, prepared by Chen and Palmer, provides a detailed analysis of possible breaches of the Bill of Rights Act 1990.

12 Refer for example to p 3 in the March 1998 *Submission Opposing Cost Recovery for Border Controls* to the Ministry of Agriculture and Foresty presented by 26 sea ports, airports, and aviation, travel, transport and tourism representatives, councils or associations.

compensation unless a tax is paid can be compared to an extortionist who makes a "your money or your life" demand of a victim. Under the avoidable cost argument the victim who pays, benefits from the extortionist's service of permitting him or her to live. Like theft, extortion by citizens is an offence because it is destructive of incentives to create wealth. Governments need to constrain themselves, or be constrained, from making arbitrary and excessive tax demands for the same reason. The avoidable cost and source of risk arguments lend themselves to predatory and discriminatory taxation because of their unconstrained nature. They thereby illustrate the importance of a disciplined and principled approach to tax issues.

3.12 Another objection is that even if the avoidable cost doctrine did not violate the Bill of Rights Act 1990 and international law, its assignment of property rights is arbitrary. As with the source of risk case just discussed, an alternative view would be that New Zealanders have a right to freedom of movement across the national border, to sell tourism services and to export and import. The benefits of any constraints imposed on those rights would accrue to those who wish to have them constrained. Under this equally extreme counter-view, New Zealand could avoid the costs of much border protection by closing pest-susceptible industries or by relaxing restrictions against the importation of undesirable visitors of all types.

3.13 Finally, the logic of the avoidable cost regime would require the government to determine what costs New Zealand would incur if international travel and trade were prohibited. Given New Zealand's dependence on land-based exports, the question is too ludicrous to pursue except to note that the logic of the avoidable cost doctrine requires cost recovery only in respect of the difference between the costs of policing the existing industry or activity and the costs of policing a ban on the industry or activity.

3.14 As this discussion illustrates, the avoidable cost concept fails entirely to consider the question of the optimal level of border protection services. The starting point for such an investigation is to determine the marginal benefit of an extra dollar spent on border protection services. The avoidable cost doctrine ignores marginal costs and makes no attempt to discover marginal benefit.

Concluding comments

3.15 The source of risk and avoidable cost arguments for recovering enforcement costs from particular groups appear to be arbitrary in their assignment of liability and unsound in their assessment of the cost to be imposed. As such, these arguments provide no stable or reliable basis for public policy decisions. They appear to be silent on the question of the marginal benefit from an extra dollar spent on enforcement. Propositions about who originally benefited from a given regulation do not throw any light on the question of the quantum of benefit derivable from an extra dollar spent on enforcement of that regulation.

3.16 The only sound approach would appear to be to treat the issues of the regulation of risk and of compensation for restrictions on property rights or liberty separately from the issue of the optimal funding of the enforcement of property rights. Once property rights in respect of risk are assigned, the public enforcement of those rights is a public good activity.

3.17 If the proposed charges for enforcing property rights are seen as a user fee, this must be justified on the grounds that it brings a better balance between the resources devoted at the margin to enforcement and the benefits of enforcement. But those on whom these fees are to be levied cannot be expected to know how much benefit from an extra dollar spent on enforcement of border protection laws will accrue either to vulnerable industries or in the form of greater respect for law and order. The absence of any cogent argument that travellers, tourism operators or those engaged in exporting or importing derive any benefit from an extra dollar spent on policing border regulation leads to the issue of the optimal recovery of border protection costs through taxation.

4 Do the proposed charges conform with sound tax principles?

4.1 Sound taxes are constitutional, respect minority rights, conform with the rule of law and reasonable concepts of equity, and have desirable efficiency attributes. All practicable taxes distort behaviour in undesired ways. The costs of these distortions are known as the deadweight costs of taxation. Optimal tax theory is concerned with raising the revenue the government requires at minimum social cost.

4.2 The proposed border charges, being based on 100 percent recovery of cost, take the form of a tied tax. Tied taxes may usefully confront users of a club good with the replacement costs of the club's facilities, but they may also sanction inefficient cost-plus behaviour, reduce the flexibility of the government to allocate funding to the highest priority areas and lead to inefficient investment in the tied facility.

4.3 In this case the revenues from the proposed charges are not being used to fund the provision of a club good. Nor is payment voluntary. Nor is the level of service being determined by those who desire to be members of a club. These features increase the risk that the tied element of the proposed taxes will increase their cost.

Constitutionality and the rule of law

4.4 As noted in Section 3, we are aware that serious legal questions have been raised about the constitutionality of the proposed charges in terms of international law and the Bill of Rights Act 1990. Regardless of the resolution of these arguments, the NZBR sees it as important for the rule of law that parliament should take a very conservative approach to requests from the executive that it delegate its power to tax. Adequate safeguards against the abuse of delegated powers to tax are essential. The incentives on administrative bodies to use any *de facto* powers to tax to expand their budgets and their influence are obvious. The Travel Industry Coalition's November 1998 submission cited in paragraph 3.11 above pointed to a disturbing lack of safeguards in the Immigration Amendment Bill 1998. For example, any charges would not be subject to scrutiny by the Regulations Review Committee.

Equity

4.5 It is grossly inequitable that one group of law-abiding taxpayers or taxpaying entities be taxed in order to police regulations or laws that are clearly designed to assist other industries and the wider public interest. The proposed tax is not to be imposed, for example, on owners of livestock, plants and trees who benefit commercially from the enforcement of rules designed to keep out unwanted pests and diseases. Nor is any case made that the implied wealth transfers have favourable effects on the distribution of income.

Efficiency – shifting the burden to foreigners

4.6 Optimal taxes seek to raise revenue at the lowest cost. The basic theory of optimal taxation posits an 'in principle' efficiency case for taxing most heavily those products for which demand is most insensitive to the tax-inclusive price. In practice, New Zealand's general approach has been to stress the unreliability of estimates of price elasticities and to opt for uniform indirect taxes so as to minimise administrative and compliance costs.

4.7 New Zealand's size and the fact that foreign travellers and exporters have access to the rest of the world for their trips and goods respectively suggests that the demand by foreigners for New Zealand's border control services could be quite price sensitive. The suggestion by the industry that the proposed charges could stop visits by some cruise ships illustrates this point. In respect of the taxation of foreign investment in New Zealand[13] and the use of import tariffs, policy makers have generally taken the view that the costs of attempting to tax foreigners outweigh any possible benefits. The same arguments appear to apply in respect of foreign migrants and visitors.

4.8 Even if foreign demand for New Zealand's border control services is elastic, it is possible that the distortions arising from the proposed taxes could be small if New Zealanders involved in importing, exporting and tourism absorb the full amount of any charges at an unchanged volume of activity. While this is an empirical question, the proposition does not seem obviously plausible and it appears to be inconsistent with the goods and services tax (GST) regime that does not seek to penalise international trade relative to domestic trade.

4.9 To conclude, any proposition that taxing foreigners provides a 'free lunch' needs to be cogently argued rather than loosely asserted. This is not to argue, of course, against user-pays charges for non-mandatory private goods supplied to foreigners.

Efficiency – incentives to scrutinise costs

4.10 Another efficiency argument for the proposed charges is that they would create an incentive to scrutinise the costs of border protection. Those involved in transporting people and goods to New Zealand allegedly have information about actual border protection levels, quality of service and cost efficiency that is superior to that enjoyed by those currently responsible for monitoring these expenditures and advising the minister of finance, cabinet and parliament about the optimal level of funding for government services.

4.11 However, the fact that information is undoubtedly widely dispersed does not come remotely close to creating an argument for 100 percent cost recovery from those whose information is superior in *some* respects to that of those who are responsible for setting budgets. One might equally argue that criminals and the victims of crime are better placed than the general public to assess how well the police are doing their jobs so that the costs of policing in any one year should fall on those who were charged with a crime or the victims of a crime in that year. Similarly, by the same argument, school teachers should bear the full costs of each others' salaries, because each teacher has superior information to the Treasury about their colleague's performance.

4.12 There is no need for the government to use coercive powers of taxation to purchase information that others possess by virtue of their investment in a business activity. If the government desires to collect widely dispersed information it can pay people to collect and provide it.

4.13 Furthermore, what is far more important than providing those with information with an excuse to complain is the need to provide an incentive to those responsible for regulating and policing border activities to relate the costs of regulations to the benefits. Under current arrangements there is a risk that the incentives of the Treasury, the minister of finance and parliament to closely scrutinise the benefits derived from expenditures on border protection will be reduced if the expenditures are 'self-funding' by a tied tax. The government's proposal to fund the Accident Compensation Corporation (ACC) 'tail' by what amounts to a payroll tax does not appear to accord with sound principles and only heightens the NZBR's concerns about the role expediency could play in the scrutiny of expenditures that do not put

13 The particular case of double-tax agreements is an exception.

pressure on general rates of tax. Those benefiting from the services will have a reduced incentive to relate benefits to costs and those providing the services will have all the normal bureaucratic incentives to inflate costs by adopting a low risk approach. Far from improving incentives where it is important to do so, the proposals would appear to weaken all incentives to relate benefits to costs.

Conformity with tax policy processes

4.14 Procedurally, it is desirable that all proposed taxes should be subject to the scrutiny of the Generic Tax Policy Process. This has not occurred and the proposed regime does not appear to conform with sound tax principles in respect of constitutionality, equity and efficiency, or with government process requirements.

Appendix Arguments in support of the 'user charge' proposals

A.1 Five arguments appear to have been advanced in support of the 'user charge' proposals:

(1) they create an *incentive to scrutinise the costs* of border protection;[14]

(2) *sources of risk* should be made to pay for the risk they impose;[15]

(3) those whose activities impose otherwise *avoidable costs* should be confronted with those costs;[16]

(4) charging port companies will *shift the burden* of bearing border protection costs from New Zealand taxpayers to foreign sources of risk; [17] and

(5) *fiscally* the proposals are useful because they would 'improve' the government's reported operating balance and its ability to reduce income tax rates.

A.2 Arguments (1) and (4) are discussed in Section 4 (paragraphs 4.10–4.14 and 4.6–4.9 respectively). Arguments (2) and (3) are discussed in Section 3 (paragraphs 3.4–3.6 and 3.7–3.13 respectively). Argument (5) is discussed below.

Fiscal effects

A.3 There is no national interest case for imposing an inefficient tax in order to fund additional spending or to reduce an efficient tax. The argument that there are advantages in off-budget funding of expenditures is not a national interest argument. To the contrary, the government's decision to fund the ACC 'tail' by way of a payroll tax illustrates the tendency of governments to find expedient and unsound ways of reducing pressures on income tax rates.

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14 Refer, for example, to p 8 of the discussion document *Cost Recovery of Border Clearance Services for Passengers and Craft*.
15 NZIER report, *op cit*, p ii (see footnote 7).
16 NZIER *loc cit*, p ii.
17 NZIER *op cit*, p iii.

DELOITTE TOUCHE TOHMATSU BUSINESS LUNCH

HOW BIG SHOULD GOVERNMENT BE?

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

AUCKLAND
14 OCTOBER 1998

HOW BIG SHOULD GOVERNMENT BE?

The question explored today is 'How big should government be?' I believe this topic will be one of the central issues in politics around the world as we go into the next century.

At the beginning of this century, governments in the advanced countries typically spent around 10 percent of national income and taxed their citizens accordingly. On this basis it could be said that the average worker spent one day a fortnight working for the government. In those days the church thought the tithe was quite a good idea.

This was an era of small or limited government, not just in the spending operations of governments but in their roles as regulators of economic activity, as owners of businesses and as providers of services. New Zealand conformed with this pattern, and at the turn of this century average income levels in New Zealand were among the highest in the world.

By contrast, the twentieth century has increasingly been one of big government. As our century ends, the broad picture is that government spending accounts for around 20 percent of gross domestic product (GDP) in the Asian region, a third or more in the English-speaking economies and around 50 percent in Western Europe. In New Zealand, the average worker spends two days a week working for the government. We have also seen in New Zealand the vast expansion of the modern regulatory state and of central and local government ownership of many commercial activities. Only in the past two decades, with the collapse of the centrally planned economies and the worldwide moves towards privatisation, have these trends been partially reversed.

The debate over how big government should be has raged throughout this century and will continue. The 1960s and 1970s were the high water mark of socialist and Keynesian ideas. Subsequently we have seen moves in the direction of economic liberalisation in all the Organisation of Economic Cooperation and Development (OECD) countries and many others, but in the economic domain and in other walks of life government continues either to remain large or to grow.

I want to focus on two contributions to the debate about the size of government that have recently been made in New Zealand. The first is the work of Professor Gerald Scully and the Inland Revenue Department which explores the size of government and the associated tax burden that maximises economic growth. The second is a speech by environment minister Simon Upton to a National Party conference last year which he entitled 'Focusing government on what it does best'. The conclusions of both contributions point in the same direction, but they reach them by somewhat different routes.

Professor Scully has surveyed data across a range of countries, including New Zealand, and has found that as tax burdens rise economic growth suffers. He concludes that the growth-maximising size of government is found with taxes around 20 percent of GDP.

I have a number of problems with the methodology of Professor Scully's study as I shall indicate, but its general findings are in line with much other economic research. For example, a study for the Joint Economic Committee of the US Congress earlier in 1998 found that:

> As the size of government has expanded in the United States, growth of real gross domestic product [GDP] has steadily fallen. Even though the United States economy is now moving into the eighth year of an expansion, the growth of real GDP during the 1990s is only about half what it was during the 1960s and well below even that of the turbulent 1970s. Likewise, as the size of government in other nations has increased, economic growth has declined. On average, government expenditures in the Organisation of Economic

> Cooperation and Development's 23 long-standing members rose to 48 percent of GDP in 1996 from 27 percent in 1960. The average economic growth rate fell from 5.5 percent in the 1960s to 1.9 percent in the 1990s.[1]

International Monetary Fund (IMF) research has come up with similar findings.[2] The New Zealand Business Roundtable published a study in 1994 highlighting the deadweight costs of taxation in New Zealand.[3] The important point which all these studies bring out is that government spending is the true tax burden. If the ratio of general government spending to GDP is, say, 40 percent, as is roughly the case today in New Zealand, the true average tax rate will be roughly 40 percent. If you want a lower tax rate, you must argue that the government spending ratio should be reduced.

Ted Sieper of the Australian National University has made a number of major criticisms of Gerald Scully's work, although he supports the view that smaller government and lower taxes would improve economic performance. My position is similar. I would have four general reservations about Professor Scully's approach.

First, his data cover the recent decades of high government spending and tax burdens. If he had surveyed earlier decades, he would doubtless have come up with a growth-maximising tax rate well below 20 percent.

Secondly, although several countries have achieved rapid growth with even smaller government, Professor Scully nowhere explains why additional government spending and transfers would add to growth. As Ted Sieper puts it:

> Here the examples of Singapore and Hong Kong are instructive. Neither of these near neighbours has yet seen the need to raise government spending from an average of about 15 percent of GDP to the level recommended by Professor Scully, yet both have achieved an enviable record of growth (8.5 percent pa over 36 years for Singapore and 6.9 percent pa over 23 years for Hong Kong).[4]

Thirdly, the focus of the Scully study is on economic growth, whereas governments rightly have other objectives such as the provision of a social safety net and protection of the environment. Would-be supporters of smaller government will be alienated if such concerns are not taken into account. Even maximising growth is a limited objective compared with the broader concept of maximising welfare – some people will prefer to trade off work and income for leisure.

Finally, trying to determine the proper size and shape of government by looking for a 'growth-maximising tax rate' is a slightly odd and roundabout procedure. Moreover, the optimal size of government clearly depends on a country's circumstances at a given time. If I had been an Israeli at the time of the Yom Kippur war I might well have been happy to see half the country's income devoted to spending on defence. The role and size of government should be determined by a more fundamental analysis of what we need governments to do at a particular time and place.

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1 James Gwartney, Robert Lawson and Randall Holcombe, 'The Size and Functions of Government and Economic Growth', report for the Joint Economic Committee, April 1998. The quotation is from an article by James Gwartney, 'Less government, more growth', *Wall Street Journal*, 10 April, 1998.

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

3 W Erwin Diewert and Denis A Lawrence, *The Marginal Costs of Taxation in New Zealand*, New Zealand Business Roundtable, 1994.

4 E Sieper, Formal Review of Gerald W Scully, *Taxation and Economic Growth in New Zealand*, Revised Inland Revenue Department Working Paper No 14, 28 March, 1996, mimeograph.

Nevertheless, whatever the deficiencies of some individual studies, there is now a large and robust body of research pointing to the damaging effects of high levels of taxation on economic performance, particularly in a world of open borders and mobile capital. These were largely ignored in university teaching a generation ago and are still routinely denied by people such as the University of Auckland duo of Susan St John and Tim Hazledine. But they are simply out of touch with modern economics. For example, a leading contemporary economic textbook, *Principles of Economics* by Gregory Mankiw, has a whole chapter on 'The Costs of Taxation' which brings out the pervasive effects of taxes on economic decisions.

Focusing on what the core role of government should be, however, is in my view a much more satisfactory way of thinking about the shape and size of government. This task is more firmly grounded in the principles of economics and public policy analysis. It is also the approach that has been followed in New Zealand during the reform period. The goal has not been 'minimalist' government or downsizing *per se*; it has been to find a proper basis for government intervention in the economy and to 'rightsize' government. Those in the reform camp have asserted a positive role for government – they have emphatically endorsed the need for governments to undertake the things that only governments can do, but have argued that governments should not undertake other activities that are best left to the private sector: this includes families and voluntary associations.

This is the approach taken by Simon Upton in the speech I referred to earlier. He gave a list of what he regarded as the essential functions of government. It comprised the basic machinery of democratic government, running the legal system including the courts and the police, producing statistical and other information, undertaking basic scientific research, protecting the environment and taking responsibility for foreign relations, immigration and defence.

Mr Upton's list is not definitive, as he acknowledged. One could add to it, for example, the role of maintaining a stable currency and keeping markets open to competition. But the key point is that the essential functions all involve genuine public goods: services which cannot be provided adequately, if at all, simply through market transactions in the private sector. We want governments to ensure such public goods are provided and to do that job well. If they don't, we end up with a less efficient economy, and economic growth – and more broadly welfare – will not be maximised.

By contrast, the job of providing private goods – those that can be bought and sold in the marketplace or organised through voluntary activities – should be left to the private sector. The list of public goods does not include things such as running Lotto, television stations, coal mines, ports, airports, electricity businesses, property companies, forestry operations, accident insurance schemes and many other activities that central and local governments in New Zealand engage in. Because, on average, government ownership of such enterprises leads to inferior performance compared with the disciplines of private ownership, it harms economic growth. It should also be noted that with changing technologies, a number of goods and services, such as roading, which were once public goods are increasingly capable of being provided and charged for as private goods.

Simon Upton estimated that the core public goods functions which he identified accounted for around 5 percent of GDP. If we were only concerned about maximising economic growth, the role of government would essentially be confined to those public goods functions. That approach, rather than searching for a growth-maximising tax rate, would be the way to determine the optimal size of government. But governments rightly have other goals as well, which largely motivate their involvement in areas of social policy. Mr Upton went on to point out that he had not included in his basic list any social expenditure, not because he did not believe the government has a role in that area but because it is subject to much more debate.

What can be said about social expenditures? All of us want people to have access to services such as health and education, but we need to distinguish between means and ends. Mr Upton made two basic points. First, he noted there is no particular need for the government to be the *provider* of, say, hospital services any more than it needs to take over the role of private general practitioners (GPs) and dentists: its duty is rather to underwrite access to a minimum standard of health care for all.

Secondly, it is very debatable whether it makes sense for the government to be the *funder* of services such as health and education for the majority of people who could afford to pay for these services themselves in a lower tax environment. Such 'middle-class welfare' involves merely collecting significant amounts of revenue from taxpayers and churning it back largely to the same people through costly bureaucracies which are under little pressure to perform. At present levels of government spending it probably costs average income earners around $1.30 (having regard to the deadweight costs of taxation, including administration and compliance costs) to obtain health or education services that they could buy directly for one dollar. There is a strong argument for targeting taxpayer funding on those who really need help to obtain social services.

Social spending could also be reduced substantially by a new attack on all the obstacles to employment that have been created in recent years and by welfare reform initiatives of the kind that are being implemented in the United States and many other countries. It is paradoxical, to say the least, that although living standards have increased enormously since comprehensive state welfare programmes were introduced – so that, for example, 96 percent of New Zealand households today have a colour television and around 80 percent or more have a microwave, a fridge/freezer and a video – the share of national income devoted to welfare is at an all-time high. Most people would be able to cover most lifetime contingencies through savings and insurance given lower taxes. But even if we were to add back as much as a third of health, education and welfare expenditures to core government spending, those functions that need to be undertaken by the state would still only amount to 14–15 percent of GDP.[5]

I am not suggesting that this is necessarily the right size of government or that we should move to such a level overnight. But there are good arguments for pressing ahead with privatising activities which governments do not need to be involved with as providers, and for moves away from universal funding of many social services. Even more importantly, the ratio of government spending to GDP can be brought down by policies that promote economic growth. This happens even without actual spending cuts if increases in government spending are kept below the growth rate of the economy. It was firm fiscal discipline of this kind that was largely responsible for the fall in the ratio of central government spending in New Zealand from over 40 percent of GDP to its low point of around 35 percent in the early 1990s.

A strategy along these lines was advocated in the report *Moving into the Fast Lan*e produced by the New Zealand Business Roundtable and the Auckland and Wellington chambers of commerce in early 1996. It outlined a comprehensive programme for reducing government spending to below 20 percent of GDP by 2005. Ruth Richardson has suggested a similar goal, which ex-prime minister Jim Bolger dismissed in his recent book as unrealistic. Some politicians never learn. Mr Bolger dismissed a number of fiscal goals which the Business Roundtable put forward in the early 1990s as "too ambitious", yet key ones were achieved even earlier than we had proposed.

Since Ruth Richardson, finance minister from 1990 to 1993, was dumped from office, subsequent Bolger administrations embarked on a spending programme of 'Think Big' proportions, that now total some $7 billion. They also failed to press on with other initiatives to 'rightsize' government. Prime Minister Jenny Shipley has inherited this

5 See Sieper, *op cit*, p 14 (see footnote 4).

legacy and the collapsing rate of growth, current account blowout and rising unemployment that have come with it. The early plans formulated under the Fiscal Responsibility Act 1994 had the government spending to GDP ratio falling to around 30 percent in 1998. It is now back up to 36 percent and rising. Yet there are many who still haven't understood the disastrous results of such policies – allegedly less 'harsh' and more 'caring' – and are calling for yet more government spending.

By raising its expenditure to GDP ratio, New Zealand now appears to be set on a course which may be unique in the OECD. After almost a century of uninterrupted expansion, big government may be on the decline worldwide. The government share of national income in OECD countries peaked at 41.3 percent of GDP in 1993. This year it is forecast by the OECD to have dropped back to 38.6 percent and to continue falling. Over a slightly longer timescale, some of the falls have been dramatic. In Ireland the ratio has declined from 50.7 percent in 1986 to a projected 33.5 percent in 1999, due largely to rapid economic growth and fiscal discipline. This huge fall in Ireland's tax burden is unquestionably a major factor in its recent strong economic performance.

Outside the OECD the picture is little different. There have been few trends towards bigger government in Asia. The major exception is Japan, where the doubling of the government sector share in its economy over the past three decades – from 17.5 percent in 1960 to 36.9 percent in 1996 – is a major factor in its present difficulties that is seldom noted. In China, government spending appears to have come down from around 31 percent of the economy when Deng Xiaoping's reforms began in 1978 to around 10 percent today, or perhaps twice that figure if the spending of quasi-government entities is also counted. New Zealand may be competing for investment and trade with many small-government economies as it goes into the next century.

Some observers have noted the recent elections of centre-left governments in Western Europe and suggest that the trends towards economic liberalisation and smaller government may be reversed. But this interpretation may miss the point. Such policies have been pursued over the past 20 years by governments of all political persuasions: the government in Beijing is not usually described as right wing. *The Economist* recently tabulated the policy programmes of 13 centre-left governments in the European Union.[6] It found that all but two of them were clearly committed to policies of privatisation and all but one to reductions in welfare. Certainly the Labour Party in Australia stood in the recent election on a platform that would have seen a return to protectionism, industry policies, labour market regulation and greater state ownership, but the electorate appears to have voted for ongoing economic reform. Even President Clinton has said that "the era of big government is over".

So where does all this leave us? My response would be that, as the US congressional study I quoted earlier put it:

> The core functions of government are vitally important. Governments serve their citizens well when they protect property rights and enforce contracts, provide a stable (and freely convertible) currency, promote freedom of exchange in both domestic and international markets and rely primarily on competitive markets to allocate goods, services, and resources. However, as they move beyond these core functions, the tax and spending policies of governments soon become counterproductive and they begin to restrain economic growth and cause income levels to fall well below their potential. This is precisely what has happened in the United States and other OECD countries in recent decades.[7]

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6 *The Economist*, 3 October, 1998, p 61.
7 Gwartney *et al*, *op cit* (see footnote 1).

New Zealand governments have moved far beyond any plausible definition of their core functions, and our economic performance has suffered accordingly. Unless the recent upsurge in government spending is reversed and spending and tax burdens resume a downward path, I believe New Zealand is unlikely to achieve strong growth and may stay mired in its current malaise. I think the countries that are most likely to prosper in the next century are those that understand the benefits of limited government.

No doubt there will be some ebbs and flows in the tide of future events. But at the end of a century of big government, we may be returning to the insights of some of the great thinkers on the subject of government who wrote at the dawn of the democratic era, and New Zealand might do well to heed them. One such writer was Adam Smith, whose study of the wealth of nations led him to conclude that:

> Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things.[8]

Another was Thomas Jefferson, whom the American columnist George Will has called "the man of the millennium". In his first inaugural address, Jefferson asked: "what more" (after the industry of citizens and the blessings of Providence) "is necessary to make us a happy and prosperous people?" His answer was:

> Still one thing more, fellow citizens – a wise and frugal government, which shall restrain men from injuring one another, which shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned. This is the sum of good government and this is necessary to close the circle of our felicities.[9]

8 Adam Smith, *The Wealth of Nations*, Modern Library, New York, 1937 p xliii.
9 Thomas Jefferson, First Inaugural Address, 4 March, 1801.

NEW ZEALAND POLICE ASSOCIATION
63RD ANNUAL CONFERENCE

GETTING A CORE GOVERNMENT FUNCTION RIGHT

DOUGLAS MYERS
CHAIRMAN LION NATHAN LIMITED
AND
MEMBER OF THE NEW ZEALAND BUSINESS ROUNDTABLE

WELLINGTON
8 OCTOBER 1998

GETTING A CORE GOVERNMENT FUNCTION RIGHT

I was as surprised to be approached by the New Zealand Police Association and to be asked to help it with the government's review of the New Zealand Police as you probably are to find me standing here talking to you.

I had never before been asked by a trade union to do anything – or anything constructive anyway.

But I readily accepted both the invitation to take part in the police review and the invitation to speak to you today for several reasons.

The first is the importance of the subject.

New Zealand is a country known for its relatively low level of crime and disorder. Not only is law and order very important for our quality of life but it is *the* core role of a government to protect citizens and uphold the rule of law. Sound and effectively enforced law is vital for the business community too – ask anyone who has tried to do business in Russia or South Africa.

However, like many things about New Zealand, the conventional wisdom about our law and order status is something of a myth. Some of our crime statistics do not compare at all well with those of other similar countries. We have to ask whether we have our priorities right when young thugs roam the streets and elderly women are raped in their beds while governments occupy themselves running things like Lotto and television stations.

In the last few months I have learned a great deal about the extent of organised crime that we seem to be doing little to combat. I have been told that elements in the criminal world have overtaken the police in terms of technology and business organisation. You know about this, and now I know about it, but the public does not know about it. Why not? Organised crime is now mentioned in the Key Results Areas laid down for the New Zealand Police, but the legal, financial and technological resources needed to deal with it are unlikely to be provided unless the public understands the threat.

A couple of years ago the New Zealand Business Roundtable, of which I am a member, published a study entitled *Controlling Crime in New Zealand* that presented the straightforward thesis that people will be involved with crime as long as it pays. This is not the whole explanation of crime but it is the main one, and it is understood by ordinary people and under-emphasised by many criminologists. Whether crime pays depends partly on the chances of detection, which depend in turn upon police effectiveness and efficiency and on public attitudes towards criminals and the police. Whether crime pays of course also depends upon the performance of the justice system in convicting people and handing out appropriate sentences.

The second reason for my interest in the review was the approach of your president, Greg O'Connor. In my experience of dealing with employees' organisations, your association's leadership is unique in understanding that the interests of the New Zealand Police and its staff are one and the same. This is to adopt the attitudes of a professional body rather than a traditional trade union and is refreshing by comparison with your counterparts in the fire service and the teaching world. It is also a necessary basis for maintaining public respect.

I know too that police staff want to do their job well, but they see themselves as frustrated at every turn by outdated management practices, perverse funding systems and incomprehensible legal barriers. Police are faced daily with the clash between their experience of dealing with victims of crime, what they hear politicians say about the importance of the police, and what they see politicians actually doing.

However, it was what politicians were doing that was the third factor that spurred my interest. Your association's action in contacting people such as myself, a management consultant and a retired senior police officer to help with the review certainly showed much greater seriousness of purpose than that of the government, which seemed to set out with a predetermined agenda to find $50 million in cash savings. There might well be efficiencies to be found in police administration, and taxpayers have every right to be assured they are getting value for money, but this is not the right way to go about the job.

Some of the review's suggestions, such as the new district structure, have been under discussion within the police for a considerable time. In respect of headquarters, the review just plucks a figure out of the air for the number of staff that could be cut. This sort of thing was supposed to have been left behind with the approach to public sector management that has been pursued since 1984. So far there is nothing in the review about reducing crime, improving the effectiveness of the police, or even ensuring value for money. There is merely an assumption that the police can go on doing whatever they are doing now with fewer people at headquarters.

In some respects the review is unambitious. It is an example of the tinkering and unimaginative approach that has paralysed public policy development in recent years and contributed to the country's present economic difficulties. It is conservative in the way it looks at the New Zealand Police, for example in considering the number of activities that could be contracted out. It focuses on the organisation and not the outcomes. What the public is interested in are things like safer neighbourhoods, security of personal property, curbing fraud and dealing with people who wilfully put others at risk on the roads. Who actually achieves these things is of secondary importance.

There have been changes in the scope of law enforcement activities in recent years, but the picture is a mixed one from the point of view of the New Zealand Police.

The Serious Fraud Office (SFO) was created because of a perception that the police lacked the structures and personnel required to tackle major fraud investigations. This is a pity because fraud will be found in much organised crime, and there is a risk that the SFO will not consider the impact of its activities on the general level of crime and the maintenance of order when it sets its priorities.

Another change was the merger of the traffic function. The jury still seems to be out on the merits of this decision, and it is not clear that all the presumed efficiencies from integration have been achieved.

The police have also taken a lead in implementing community oriented policing, although much of the impetus has come from the crime prevention unit in the prime minister's office. But the crime prevention strategy shows how wider government policies need to change. It is one thing to set up Safer Community Councils. It is another to ensure that real change occurs in other agencies that need to be involved with community problems. It is no good, for example, lecturing schools about truancy and taking up their time and yours with committee meetings when the fact is that no one, least of all schools themselves, has any incentive to get these children back into class. If schools were paid, and paid only, for each day a child attends, we would see imaginative solutions to the problems of suspension and truancy spring up overnight. If truancy leads to crime, then the police need that problem to be tackled effectively and holistically. The Business Roundtable study argued that the Children, Young Persons, and Their Families Act 1989 and the family group conference system of dealing with young offenders should be also reviewed – both seem to have made it more difficult for the police to catch juvenile offenders and for them to receive appropriate punishment.

Likewise, the police should not go on ignoring the private security industry whose staff may now outnumber police staff. You can regard them as a competing force to be thwarted at every turn if you like, or you can regard them as thousands of extra pairs of eyes and ears and a means of freeing police to concentrate on core activities.

So the police face challenges from several directions. The overriding one is to get the government and the public to understand that the concern should be with best value and effectiveness, not with cheeseparing. I understand that the message that the Police Association leadership has received from its members is that change is required – maintaining the status quo is not an option. This is a most unusual stance for an employees' organisation. It should present your leadership and the police administration with a great opportunity to build change around sound perceptions of what is needed.

At present, the feeling seems to be that change is something being imposed on the police by the Treasury and others who do not understand what policing is all about. The failure of the police leadership to anticipate the need for change leads to exasperation in the Treasury, and the imposition of change by the Treasury leads to disgruntlement amongst operational police staff. It is a lose-lose situation. To turn it into a win-win situation, all parties need to change their attitudes – from the minister to police officers on the streets.

My experience has been in business. Once New Zealand business was a cosy protected world, but no longer. Business today operates in a highly competitive environment in which we survive only if we set ourselves standards of excellence in the services we provide. We have had to change our ways fundamentally to achieve that, and those that failed to change have failed to succeed in the new world.

That has meant changing our attitudes, our organisations and often our personnel. Some people thrived in the changed environment while others couldn't cope. When nothing in your previous experience or training has equipped you to deal with a new world, it's a considerable challenge to adapt.

The task of the leaders of any organisation is not just to be able to perform the organisation's core tasks well, it is to be able to relate to the outside world and to prepare the organisation to meet its challenges. This is where effecting change in the public sector becomes taxing. In the private sector, members of senior and middle management who cannot accept change typically go. But in the public sector they normally do not get removed, with the result that junior staff are frustrated and demoralised.

More than ever today the need at all levels is for quality personnel. At the top, leaders who can inspire and lead change. In middle management, people who are flexible and committed. And at the junior levels, staff who understand the need for change and who feel that they have contributed to it rather than had it imposed on them, and who have the chance for career development.

Let me be clear that I am not saying that there are no such people at each level in the New Zealand Police. But in many ways they are there despite the system, not because of it.

Nowhere along the line is much being done to encourage the fresh ideas that are essential in any organisation in a changing environment. The recruiting system does not seek out people with fresh ideas, the promotion system does not identify and advance them, and the training system does not inculcate the kind of thinking required. What is required is not necessarily formal qualifications, but diversity of experience and ability to think laterally. I suggest there is no reason for the current emphasis on in-house training for police, which is very expensive – polytechnics and other institutions should be used where they can offer suitable courses.

It is highly unlikely that fresh ideas and dynamic leadership through change will emerge from someone who has not had time to think outside the square. A senior British police officer, like the current commissioner of the Metropolitan Police, Sir Paul Condon, has spent four to five years during his or her career away from the daily pressures, with time to think about the future needs of the police. Some senior New Zealand police have had the benefit of study opportunities like Harkness fellowships, but many police have had to obtain their degrees part time while working as police officers. While this shows tremendous commitment and determination, it does not provide time for detached reflection.

A key contributor to Lion Nathan's success was human resources director, Joe McCollum, who came from New York with a background in multinational companies. We knew that as a small company by world standards we could not hold on to him for ever. But if the only way New Zealand institutions can attract world-class people is by accepting that they will not have a long-term commitment to them, then so be it. For nine years we had the benefit of an executive of international calibre and I took real pride in the fact that what he achieved and what he learned at Lion Nathan got him the job of human resources director of ICI in Britain, with responsibility for tens of thousands of employees and reporting directly to the chief executive officer.

But long-term human resource policies do not interest politicians much. They do not see them as providing the quick fixes they are looking for. Like superannuation, the quality of the police in 10 years' time is going to be someone else's problem. This is frustrating in the extreme, because in fact a good, well-articulated human resource policy can have a surprisingly swift effect on attitudes and culture right through an organisation.

For their part, police unions have traditionally not backed imaginative human resource policies, concentrating instead on rules and procedures for promotion. This is a pity. You should be prepared to take things like performance pay more seriously. A professional body's concern must be with the working environment of the next generation of its members and the overall performance of the organisation. Its highest priority should be to support inspired leadership and imaginative human resource strategies.

This leads to the question of what sort of people the most senior officers should be. At present the New Zealand Police is effectively a closed shop. But the benefits of opening up your career structure to outside and overseas competition are enormous. However good you are, you will always benefit from contact with fresh ideas and methods. If the *status quo* is not an option, new skills may be required to lead the police through a period of change.

However, it is not enough to have high quality police leadership. There has to be political leadership as well. The New York City police were only able to do what they have done to combat crime in New York because mayor Guiliani made it a priority. Sir Robert Mark, the commissioner of the Metropolitan Police in the 1970s, makes it clear in his autobiography, *In the Office of Constable*, that his achievements were only possible because he had the backing of the Home Office.

So the impetus has to come from the top. The prime minister must take the police function seriously and not regard it simply as a source of cash savings. A minister must be appointed who can do the job required. I hope that Clem Simich can, but the process of the recent review does not inspire much confidence that the government considers the minister of police important. The previous minister does not seem to have been part of the review process at all. It seems to have gone directly from minister of finance Bill Birch to the commissioner and back again.

We also need the policing function to have the support of other key ministers. Crucially, we need a minister of justice who understands that they have a major contribution to make to the government's public safety objectives. The performance of the current minister has been abysmal in this respect. Although he rightly criticised the Bill of Rights Act 1990 in opposition he has done nothing about it while in government. He has allowed the New

Zealand Law Commission project on police questioning to drag on for years, leaving the police rudderless. He has been captured by inexperienced and legalistic staff in the Ministry of Justice. The Law Reform Division was so awful that business law had ultimately to be taken away from it and given to the Ministry of Commerce. But the ministry's performance in reforming law affecting the police has been no better.

Neither the Ministry of Justice nor the Law Commission seems to have the stomach for a fight with the criminal defence lobby and its media friends. I would like to see a thorough investigation into whether rules of evidence and other court proceedings have tipped the balance too far in favour of accused persons. I see that we now have one in 10 jury trials ending in a hung jury. The resulting wastage of police and witness time is enormous. Is the minister interested in looking at majority verdicts, which Britain has had for over 20 years? Evidently not. He is very interested, however, in community magistrates, though no one else has been able to identify why there would be net benefits from their creation.

Regrettably, too much of what we hear from politicians on law and order issues is posturing. Calls for greater police numbers and to get more police out of offices and on to the streets do not get us very far. Nor do slogans like 'tough on crime; tough on the causes of crime'. Harder thinking is required.

I would like to think that the current police review will move into a phase of harder thinking. There are good reasons for concern about crime in this country and plenty of scope for new strategies for controlling it. Some ideas were put forward in the Business Roundtable study that I mentioned earlier, and there are many others. The thoughts that I would like to leave you with today are these:

- Maintaining law and order is a core government responsibility.

- We need governments to concentrate on their core functions and perform them well; conversely they should shed many other unnecessary functions.

- The fact that the police service at large accepts the need for change is very encouraging. The Police Association should not try to defend the indefensible, including some conditions of service. The police need to be seen to be open and accountable for the very large taxpayer resources devoted to them.

- Equally, the police should be entitled to expect supportive and intelligent treatment from all arms of government – not slash and burn exercises.

- The police review needs to be restarted on a fresh and much broader basis if it is to result in more effective policing and crime control.

- The police deserve the support of all sections of the community, including the business community, in pursuing such goals, and if I can continue to make a useful contribution to this process I shall be happy to do so.

AIC 1998 NEW ZEALAND ROAD REFORM CONFERENCE

THE VALUATION OF ROADS

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THE VALUATION OF ROADS

I Overview

This paper aims to establish a number of propositions concerning efficient prices for road network services and their relationship to book values and assessed values of net cash flows.

The prime conclusion is that book values and assessed values based on net cash flows are irrelevant to the determination of efficient prices. It is book or assessed values, not prices, that may need to be adjusted when they are out of line with the present value of the net cash flows expected from efficient prices.

The conclusion is consistent with the *status quo*. Book values already exist for public roads. Their establishment, rightly, did not affect road charges.

A related observation is that efficient prices can only emerge from competitive processes. These prices are inherently entrepreneurial. They cannot be discovered by officials, Transfund, the Commerce Commission or the Privy Council. Prices imposed on road providers from such sources will only be efficient by remote chance. Incentive problems inherent in public ownership impair the entrepreneurial nature of the prices offered by state providers.

Of necessity, the discussion has to distinguish between market-discovered product prices and asset values and the prices and book values that might be set by a dominant government-owned supplier, whether or not it negotiates with Transfund.

Since corporatised, government-owned road companies are modelled on market arrangements, the paper begins with an examination of the relationship between product prices, book values and market values *when market processes prevail*. Section II explains why market-determined product prices do not depend at all on past network costs or book values. It also explains why assessed asset valuations are likely to differ markedly from market values. The discussion brings out the potential importance of for-profit structures and profit-maximising motives for the discovery of consumer preferences and harnessing capital for capital intensive activities.

In the absence of market processes, product prices and book values have to be administratively determined. Section III suggests that government-owned trading enterprises should be responsible for determining product prices and book values, subject to familiar (and any unfamiliar) constraints. It argues that the costs of setting up a contest between a government selling agency and a government buying agency in order to determine asset or enterprise values are likely to exceed markedly any benefits.

Section IV highlights the dangers arising from attempts to use assessed asset or enterprise values to constrain product prices. The conceptual indeterminacy of this approach, given its circularity, is obvious. Although of no intellectual merit on this account, the idea will not go away because it is useful to those who wish to use the state's regulatory powers to increase producer surplus at the expense of consumer surplus, or *vice versa*. The discussion in this section therefore focuses on the practical implications of such an approach. In practice, it amounts to rate-of-return regulation – one form of price control.

Section V considers in general terms the likely relationship between efficient prices and the net cash flows likely to be derived from road companies.

For the convenience of readers, the remainder of this overview summarises the discussion by putting forward, and briefly commenting on, the following eight propositions.

1 Efficient road prices track marginal user benefits and provider costs. Road assets are highly specific and the past costs involved in constructing the road network are largely sunk. Past costs are therefore irrelevant to the determination of efficient prices. In contrast, current and future maintenance and capital costs are avoidable and do matter for efficient pricing

Comment: Opportunity cost is the only economically relevant cost. Only avoidable costs have an opportunity cost. Past costs cannot be affected by any current decision. Therefore past costs are irrelevant to the determination of marginal cost.

The continuing use of assets in a current activity has an opportunity cost when they have some value in an alternative use. This is usually the case, which is why local authorities and the Crown generally need to take into account the value of their assets in an alternative use when considering the wisdom of continuing to employ them in their existing use.

Roads are arguably very different from this general case. The replacement cost of the road network is perhaps $60 billion. But the value of the roads, bridges, tunnels and the land forming the roadbed is probably around zero in an alternative use. Economists define costs that cannot be recovered if their existing use is abandoned to be *sunk costs*. Assets whose value is largely specific to their existing use are called *specific assets*. The road infrastructure is a highly specific asset and past costs are largely sunk.

Implication: The ongoing maintenance of mature parts of the road network with static traffic flows and no congestion is commercially justified if those wishing to use these parts of the network are willing to meet the costs. In terms of economic efficiency, there is no case *per se* for imposing subsequently a capital charge to recover past sunk costs. Future capital costs are part of marginal cost and so are relevant to prices. For example, the cost of replacing a washed-out bridge or road is part of marginal cost.

2 Efficient prices will also reflect value-for-money to consumers at the margin

Comment: Users do not care about providers' past costs or the book value of their assets. Users do care about road prices relative to the costs of alternatives such as transport by air, sea, rail, walking, biking, buses, the greater use of telephone, fax, email or post, or relocation options. Prices of substitutes are relevant to the determination of efficient prices. Users will not pay more than the cost of a substitute simply because the cost of supply is greater. Users only care about supplier costs when they think charges are monopolistic. Commercially set prices for road users would be determined by road-owning companies' property rights, product market conditions and any constraints set by shareholders.

With efficient prices we must expect users at the margin to be indifferent as to whether they use road, rail, air or sea, where these are competing options, or to use their car, bike, walk or live closer to work where these are options. How closely road user charges track charges for transport by rail, sea or air depends on user valuations of such intangibles as convenience, safety and time.

In a nationalised industry framework, the key point to note here is that what can be charged for any product depends not on what it costs to provide but on what consumers will pay for it where they have a choice. (If they have no choice, price performs no allocative role; any price is as efficient as any other price.)

3 Each supplier must determine the terms at which it will supply products or services and a book value of its assets. But no commercial supplier can fix price *and* quantity for products. Furthermore, the supplier must modify the price offered if user responses make it clear that it is not commercially

sustainable. Similarly, no supplier can expect the book value it sets for its asset to affect the prices for products that it can sustain in the market place

Comment: Profit-maximising suppliers adjust price, quantity, quality and product ranges according to their perception of market demand. The prices and quantities that emerge from this interactive process can be thought of as market-determined, even if there is only one supplier. However, this interpretation depends on the supplier's incentives to respond to user signals. Where the supplier is government-owned the shareholder may not act as a profit-maximiser. In this case, it may be more accurate to interpret prices as being government-controlled. Users will adjust demand so that price reflects marginal user benefits, but such a price is unlikely to reflect marginal cost.

Profit-maximising providers have a strong incentive to set prices that discover user preferences and to minimise costs. The for-profit structure may also be important for capital raising in capital intensive industries. Price control and rate-of-return regulation are a threat to the entrepreneurial processes for discovering prices and costs.

4 Ideally each road company would determine the book value of its assets for itself, subject to the normal accounting conventions and the approval of its shareholders

Comment: Book values for road companies could simply be set initially at the existing book values for the roads they own (basically depreciated replacement cost). Should initial book values prove to be egregiously out of line with the present value of any road company's net revenue, the company's board would be responsible for advising shareholders and proposing amendments.

There will probably be different book values for different purposes, as occurs at present in the case of publicly listed companies owning forestry roads. These values would have no implication for pricing. For government-owned companies, current book values provide a possible starting point.

5 Market values for the rights to assets are the greater of their value in an existing use or in an achievable alternative use. No asset owner can fix this value since it depends instead on what others are prepared to pay for the rights to the asset

Comment: A market value can only emerge from a market process in which competing views about value are contested and resolved.

What is the relationship between market price and value? Technically, this depends on the relationship between marginal cost and average cost. To illustrate the complexities, suppose that the prices that emerge from market processes track the marginal cost of providing additional units and that these are also the prices that must prevail in respect of all existing units of supply. Suppose also that the assets employed have no value in an alternative use. The value of such a firm is positive, zero or negative according to whether the cost of supplying the marginal unit is greater than, equal to, or less than the average cost of supply.

6 Assessed values are not market values

Comment: Anyone can hazard a guess as to a yet-unobserved market value. Guesses are cheap. Any competent financial analyst can calculate an assessed value from estimates of earnings and costs. This is more costly, but such estimates are not market values.

Experts can calculate the net present value of the future cash flows that might accrue to road companies. These assessments may depend heavily on what property rights the assessors assume can be exercised by the road companies. Government decisions concerning the degree to which road companies are entitled to the revenue from future taxes on road users and from access charges imposed on road users may be critical here.

Sharemarket values often humble the experts, even when the assessments are made only hours before market trading occurs. Assessed values are not market values.

7 Assessed values lack the objectivity of a market value

Comment: Commercial values are derived from the difference between future revenues and future costs. Views about the future are subjective. In particular, views about future demand and supply technologies and costs are subjective and entrepreneurial. The product prices and market values that emerge from market processes reflect the impersonal outcome of the contest between different views about the future. Assessed values merit no such recognition.

Since marginal cost is a subjective, opportunity-cost-based concept, experts can be expected to disagree about the estimates of marginal cost. In the absence of any market process for resolving such a contest, arbitrators' choices between expert assessments are likely to be largely arbitrary.

8 For the same information cost reasons, assessed values provide little guide to the issue of the exploitation of monopoly. Again for the same reasons, competition provides the only effective long-term answer to the monopoly problem. Given the incentive problems inherent in government-owned entities, private ownership provides the best long-term hope for an efficient road system

Comment: Information costs and incentive problems make any attempts by governments to control monopoly problems through government ownership, price control or rate-of-return regulation at best problematic. Such measures are all too likely to reduce competitive pressures and lead to the *de facto* exploitation of any monopoly power through the excessive cost structures associated with cost-plus behaviour.

Monopoly issues loom largest in any transition from a government-dictated situation to a competitive, corporatised structure. If deemed necessary, there are many transitional devices that could be used to reduce user concerns about future prices to a level that permits reform to proceed. One approach would involve 'Kiwi share' constraints on owners. Another might involve prices set through competitively tendered contracts for the maintenance of existing roads. In all cases, it would be important for full efficiency to ensure that the constraints put on the ability of new entities to compete and on incumbents to discover user preferences were temporary rather than permanent.

II Market-discovered prices and values

Views about future costs, benefits and values are subjective and can vary markedly across individuals. Whose views should prevail? What compromises should be made?

Market processes provide answers to such questions. They provide a forum in which competing views about the future evolution of benefits and costs can be contested and resolved. The judges are diverse, sometimes multitudinous, customers. Their 'votes' are spontaneous and uncoordinated. Voting is as continuous as is supply, and evolves with new information. No single mind or authority can determine the overall outcome.

Market prices have the desirable attribute that they track, at the margin, consumer benefits and the lowest costs of supply as perceived by existing and would-be suppliers. Administratively-determined prices lack this interpretation.

Market values differ fundamentally from the economic notion that the value of an asset is the sum of the producer and consumer surplus that it generates. They take no account of any economic rents in the form of consumer surplus. For example, the low market value of water, where water is plentiful, does not incorporate the enormous surplus New Zealanders derive from the inframarginal units that are essential for survival.

Market values essentially measure the value of producer surplus less fixed costs. In particular they do not include consumer surplus – the value consumers derive (on inframarginal units) in excess of the amount they pay the provider. Market values are derived from marginal, not average, consumer benefits.

Market values are objective in some important senses. First, the price at which a commodity or asset changes hands is a matter of verifiable fact; it is not an opinion.

Second, as long as the market price depends on quantity, as is normally the case, its level depends on the spontaneous and uncoordinated buying responses of diverse customers. Any supplier can fix a price, but no supplier can dictate quantity and price.

Third, market prices and values embody more information than can be commanded by the mind of any one person or group of people. They reflect the enormous amount of information that is embodied in the buying decisions of all customers and in the judgments made by all actual and potential suppliers about future supply conditions.

Fourth, the search for value for money tends to make market prices and values relatively objective. Each individual customer is free to vote solely according to the value they expect to derive from the product or service. In responding to the contest amongst providers, consumers have an incentive to disregard any individual supplier's protestations of superiority based on expertise, prestige, social position, race, religion, gender or political clout. They allow the underdog who may not even be registering on the dominant player's radar to confound some, most, or all the experts and sweep the pool in a few short years. As the American economist Thomas Sowell has commented, prejudice is cheap until we let it lead us to sell cheap and buy dear.

(Of course, the prices and costs that emerge from market processes are not value-free. Nor, except by coincidence, would they be at the levels that would prevail in a zero transaction cost world. But no other process for setting prices and values would pass either of these tests.)

Value accrues only to individuals. Which individuals benefit depends on the assignment of three crucial property rights: the right to determine to what use an asset is put; the right to derive income from the use of the asset; and the right to the proceeds from the sale of the asset. An asset has no intrinsic commercial value that is independent of property right assignments. The asset values determined in the market place are the values of the property rights being exchanged in relation to an asset. They therefore depend on the assignment of property rights in the asset.

Even well-informed assessments of pending market prices and values may be unreliable. This is because information relevant to the assessment of future supply and demand conditions is so widely dispersed and costly to collect. New information could quickly make old information about potential demand and future costs outdated. Markets allow the uncoordinated decisions of the masses to humble the experts. They can also humiliate governments, as the Asian crisis illustrates. That is one reason why many academics and politicians don't like market prices and values.

Each firm determines the *prices* at which *its* products will be offered. Regardless of costs or asset values, each profit-maximising firm has an incentive to set prices as high as competitive pressures will permit. The key constraints on prices are market competition and consumer willingness to pay. These constraints include the Commerce Act 1986. Of course, government taxes, laws and regulations will also affect prices.

Non-profit firms do not have as strong an incentive to discover consumer preferences concerning willingness-to-pay as do for-profit firms. They may also find it harder to raise the capital necessary to be successful in dynamic, capital intensive industries. Road networks are capital intensive.

Each firm will also determine what *book values* to put on *its* assets. Company directors have to 'sign off' on these values. Shareholders do not take responsibility for their directors' decisions. Companies set book values periodically according to accounting conventions. These values may be important for tax purposes. Changes in these values may or may not usefully signal to investors the changed opinions of management and directors as to the value of assets in an existing or alternative use.

In contrast, the *market value* of the company and therefore of its assets is not determined by the company's management or directors. The market value of the firm and the assets it owns is determined instead by arms-length transactions in its shares.

Market values for assets are the higher of their value in their existing use and the higher of their value in the best achievable alternative use. The value of assets in their existing use reflects the producer surplus expected from the prices that can be sustained in the competitive market place. If the value in their existing use does not at least match their value in their best alternative use, the existing use is currently uneconomic.

Market values of assets are useful to management. The value of an existing asset in its best alternative use puts a floor on the required surplus from the use of the asset. By using information about other production costs, managers can determine what combinations of product prices and sales volumes will be required to make the proposed asset use viable. However, no producer can dictate that consumers will buy at those prices. Values of assets in existing use have to be inferred from sustainable market prices; values cannot be used to determine sustainable market prices.

Unlike book values, market values will respond instantaneously to perceived changes in future supply and demand conditions, even if these changes cannot be observed because the market is so illiquid that transactions are rare. The balance of diverse opinions about future prices and costs that is embodied in any observed market price may change at any moment. If, for example, an unexpected wave of immigration puts pressure on rental housing, current and future rents and house prices will move simultaneously.

Market values will incorporate any information content in book values, but they are not determined in any way by book values. Market values can easily be double or half book values at any point in time. Particularly given the lags in revising book values, changes in book values are likely to lag rather than lead market opinion. Some research studies have found that changes in book values do not systematically affect companies' share prices. Although historic cost accounting conventions tend to make book values conservative in inflationary times, other pressures on companies exist to relate book values to market values. These include the need to provide credible values to investors and bankers, the threat of takeovers, and trust deed provisions.

These points can be summed up in relation to a private company that owns a road network and is certain that it is only subject to light-handed regulation as follows:

- management would be responsible for assessing future costs and demand and for setting product prices;

- the board would appoint and monitor the chief executive office (CEO), sign off on the overall corporate plan or strategy and take responsibility for reports to shareholders including the annual general meeting and the company's accounts;

- share prices would be determined by shareholder transactions, not by the company or the board;

- each shareholding company could decide for itself (subject to accounting standards and tax rules) what book value it chose to attribute to its holding in the road company; and

- product prices would be determined by competitive conditions in the markets for the firm's products regardless of the implications for book values, market values or calculated accounting rates of return.

What prices might emerge from such a structure? This is unknowable in detail for all the reasons outlined earlier. However, in a competitive market, in which alternative transport modes exist for the transport service being priced, competition can be expected to force prices for road travel to be limited by the price of the alternative. Thus rail and sea fares and charges will limit the prices that travellers and conveyers of goods will be prepared to pay for the use of the roads. Differentials will reflect the value put at the margin on speed, convenience and flexibility. The relationship between the cost of light plane trips from Wellington to Picton and the cost of a rail ferry passenger fare across the Cook Strait illustrates the point. For shorter distances, commuters will balance the cost of use of a motor vehicle against the cost of walking, cycling, living closer to work or using the telephone. Commuters and truck operators will require road providers to justify differentials between charges for shorter trips and charges for longer trips. Road providers' responses will be constrained by the Commerce Act 1986 (and, realistically, by the climate of customer opinion and the implicit threat of 'heavier' regulation).

It is also relevant that most roads are uncongested all or most of the time. Furthermore, it appears that a large proportion of road maintenance costs is not use-related. For both these reasons a commercial road operator might be expected to keep use-related charges on uncongested roads down in order to encourage greater patronage. A precondition would be an ability to collect and retain non-use-related charges. The levels set for non-use-related charges would be constrained by the same factors mentioned in the previous paragraph.

Monopoly issues are likely to be significant to the public in any transition from government-determined prices to more commercially or market-determined prices. This is because most people have made decisions about location and transport options on the basis of existing pricing structures, but without the protection of long-term contracts in relation to transport costs. To change their place of residence or work for most people is costly in many ways. Opportunism by both parties makes it hard to negotiate long-term contracts after roads have been built and location decisions made. However, there are many possible solutions to transitional issues. It is important that any measures designed to alleviate transitional problems do not become permanent barriers to the evolution of more efficient arrangements. Material transitional constraints will affect the value of the roads.

What book values would a commercial operator put on the value of the roads? Owners of private roads, such as forestry roads, have already answered this question. One major company, for example, distinguishes in its books between 60 and 80 different types of roads. Some roads are capitalised, based on their construction cost, while the remainder are expensed. Capitalised roads are depreciated for tax purposes. Separate books are kept for balance sheet purposes. Maintenance costs are expensed.

What if a private operator buys roads from a government agency? In the case of the state highways there would be two starting points – the price paid and the book value of the state highways in the Crown's Financial Statements. This value is currently $8.4 billion. In the case of local roads bought from a local authority essentially the same starting points apply. Local authorities typically calculate book values for roads as the sum of the unimproved value of (adjacent) land plus improvements at depreciated replacement cost. Another possibility might be for the new commercial operator to calculate independently an optimised depreciated replacement cost for the roads purchased. Analysts and management would no doubt have in mind, as a 'reality check', that the value should be plausible in relation to the company's expected net earnings and the amount paid for it.

III Administratively-determined values and prices

As long as public roads continue to be fully owned and controlled by central and local government, governments cannot rely on market processes to determine:

- prices for road use that balance marginal user benefits and marginal costs;
- the market value of the ownership rights attached to the road network; or
- book values for the roads.

In the absence of market processes there is no objective way of determining which *pricing* structures and levels best balance cost and demand. This is because there is no objective way of resolving contesting views about future supply and demand conditions.

Nevertheless, there are sound reasons for expecting efficiency gains from measures that emulate a commercial structure while retaining government ownership and control (ie from corporatisation). By analogy, a government would make a corporatised road *provider* responsible for determining the *price structures and levels* at which it is prepared to offer road infrastructure services. These determinations would be subject to the constraints outlined earlier. They would also be subject to whatever constraints were specified by the road operator's shareholder in setting up the company, appointing the board, and approving the board's strategic plan.

If central or local government, as owner, did not trust the company's board to set prices subject to these constraints, it should change the board, further empower it, or tighten the constraints implicit in the company's articles or its approved strategic plan. Alternatively, as regulator of the roads, the government might see it as necessary to alter the competitive constraints on the road company in order to improve outcomes.

Existing *book values* might be used for the roads of government-owned companies. One option would be for the central or local government owner to determine initial book values for the new companies in this manner as part of the process of transferring ownership rights in the roads in question to the new company. Where the new road company took over responsibility for a road network previously owned by more than one general government entity, each might be allocated shares in proportion to each entity's book values. The inaugural board would take these values as givens in assuming its responsibilities. It could put alterations to these book values to shareholders at any future occasion.

This approach could be very cheap compared with the alternative of determining book/share transfer values of the assets in question by setting up a legal and bureaucratic negotiation between boards as purchasers and the government as sellers of the assets in question. The Crown can cost the hapless taxpayer many millions of dollars when it sets up a contest between contending expert views. When the original State Owned

Enterprises (SOEs) were set up, a contest was created between the valuations of the SOEs' boards, acting as purchasers, and the Treasury, reflecting a selling interest. Each hired its own experts. All the expenses of both parties were met by the taxpayer. No party had a financial incentive to compromise. Nor is there good reason to expect views about the future to converge with the expenditure of more money and time. To the contrary, positions could become more sharply defined and entrenched. Ultimately, this process is only likely to end when an outside agent, with the power to do so, imposes a solution. This imposed solution is unlikely to embody any superior wisdom or freedom from prejudice or politics than is embodied in the expert opinions employed by each side. Indeed, it is likely to reflect less expertise (but not necessarily less wisdom) and more politics and prejudice. Given that such a solution is likely to be required in any case, it might be better to adopt it at an early stage.

As already mentioned, book values should have no implications for product prices. This is not novel. The book value for the state highways that materialised with the birth of the Crown's Financial Statements was rightly treated as an accounting exercise that had no implications for road pricing.

This does not mean that book values should bear no relation whatsoever to revenues and costs. Where assessed values are egregiously inconsistent with the net cash flows from an existing use, questions will be raised as to the basis for persisting with those book values – or for continuing to devote the assets to their existing use. But, in the market place, they would have no implications for price in existing use because price levels are determined by market conditions regardless of book values.

The above proposals, if adopted, would not eliminate the pressure to assess what value might be derivable from the road infrastructure if others were allowed to bid for road companies' ownership rights. This is a valid hypothetical *market value* question. Indeed, governments, as shareholders, have a duty to ask if the road companies they own are providing value for the taxpayers' money locked up in the government's shares in the company.

However, there are severe limits to the precision with which this question can be answered, short of auctioning the shares. Anyone can express a view about what a market value might be if a market existed, or about how consumers at large might respond to a given pricing structure. Guesses are cheap. But slapping a hypothetical value on something that does not exist does not make that value interesting.

Should a government desire to determine a market value, in the absence of a market, is it hard to see how it can do better than hire independent experts to provide a professional opinion. For further assurance it could subject this opinion to peer review. However, even expert opinions about a pending market value will have wide margins of uncertainty. Any analyst can capitalise a stream of future benefits and costs or apply a price earnings multiple to one year of earnings. But, as any project analyst knows, estimated values are commonly highly sensitive to the assumed price/earnings multiple or discount rate, projected costs, revenues and terminal values. The breadth of the plausible range for the unobserved market value of an asset depends on the situation. However, even assessments made when all the major participants have identified themselves and only a few hours remain before the auction takes place or the new market commences can be embarrassingly wrong – as the recent AMP float illustrated.

Ultimately, any decision as to the likely market value of an asset is an entrepreneurial decision. It reflects a subjective view about the future.

IV Dangers with using asset values to set prices

The concept of determining a value independently of prices and using that value to set a price is alien to a market approach. Any imposed process for so setting or constraining prices is far removed from the concept of competitive prices that track user benefits and supplier costs at the margin.

Apart from being unobservable in the case of roads, market values do not exist independently of prices. Even where market prices and values exist, the latter cannot be used to derive prices with any accuracy since future costs are also unobservable.

Nor can a market value for roads be defined that abstracts from careful consideration of the property rights attached to the ownership of the roads. Values can only be attributed to the property rights associated with road ownership. Any value depends on the assignment of property rights and cannot be measured independently of that assignment.

A major potential influence on the value derivable by any future owner of the roads is the assignment of the right to petrol excise revenues. Suppose central government retains these rights, in whole or in part, on optimal tax grounds. Under current accounting conventions, central government does not treat future taxes as an asset in the Crown Financial Statements. It would not show those future revenues as an asset regardless of who owns the road networks. But neither could any entity owning the roads that did not have a right to these revenues. This means that no one could hope to value the roads usefully until central government determines what proportion of current revenues are a tax that do not form the property right of any potential owner of the roads.

A related problem concerns uncertainty about the future levels of such 'optimal taxes'. In reality, the technical calculation of the optimal tax element is so imprecise that its magnitude would be politically determined. In the extreme, the government could alter the value of the roads in any road operator's books at will by altering the excise tax on the operator's users. If so, the market value of the owner's interest in any roading entity could be very small unless the government made a credible commitment concerning future tax levels.

Revenue from local authority rates that is used to fund roads raises the same issue. If the rights to that revenue are not attached to ownership rights to the roads, no owner could attribute to the roads the value of that revenue.

More generally, the value that anyone with an ownership interest in roads would put on that interest depends on what freedom they would have to set, and retain the revenue from, use-related charges (eg congestion charges) and non-use related charges such as annual registration fees and drivers' licence fees. In the absence of any government-imposed constraints, this would depend on subjective judgments as to what charges would be found to be in violation of the Commerce Act 1986. However, government-imposed constraints – such as a requirement to maintain the existing network – are already being mooted.

Using an administratively determined valuation to set prices amounts to rate-of-return regulation. This is a form of price control. The Optimal Deprival Value (ODV) and Optimised Depreciated Replacement Cost (ODRV) methodologies have this price control characteristic as soon as they are given the force of law by some regulatory or judicial process.

Practical business people and regulatory economists alike know the serious deficiencies inherent in price control. They remain the strongest rationale for New Zealand's attempt to sustain a regime of light-handed regulation.

Anything that amounts to price control will distort price/quality decisions and is likely to impair providers' incentives to minimise costs. Asset values depend on views about the degree to which the price regulator will allow incurred costs, including an attributed rate of return on capital, to be recovered. Price or rate-of-return regulation is likely to encourage the provider to adopt whatever accounting conventions would maximise the post-purchase book value of the asset.

V Relationships between efficient prices, book values and net cash flows

How should road prices be set if they are not to be set at levels derived from administratively determined values? What are the implications of those prices for the values of the roads in central and local government's books and for the cash flows accruing to road providers?

Under the corporatisation model discussed above, and in the absence of an optimal tax argument or a market, prices set by road providers and recoverable by them would aim to track marginal cost. (Marginal cost would encompass the marginal cost of use and of access.) If the government imposes optimal taxes on road users, the tax-inclusive charges would be correspondingly higher than the assessed marginal cost of supply (modified by demand and supply elasticities).

The first question for the road operator is whether the revenues it receives from such prices cover the expenses involved in maintaining the network. If prices track the cost of an additional unit of supply at the margin, projected network expenses (including the cost of future capital) will be covered as long as the cost of the marginal unit is no lower than the opportunity cost of supplying the average existing unit.

If marginal cost increases with increasing demand, or is constant, marginal cost pricing creates no supply difficulties. As long as land values rise through time and the earliest roads were built on the most convenient and appropriate sites, it seems reasonable to hypothesise that the marginal cost of additions to network capacity will increase through time.

Even where the marginal cost of new capacity rises through time, losses could occur on an existing road simply because traffic volumes grow more slowly than forecast, leading to greater under-utilised capacity than expected. Although such risks are very real, there is nothing here that is unique to roads. Hydro-electric dams, airlines, hotels, cinemas, conference venues, and other special-purpose buildings share this feature of specific assets. When there is excess capacity, a commercial provider would consider pricing use, for at least some categories of users, at short-term marginal cost. Hence the availability of discount airfares and hotel beds at times of excess capacity.

During periods of excess capacity, a road provider's surpluses may be well below those that would be consistent with its book value. Conversely, when roads are congested and congestion pricing is feasible, rush hour prices could be set at the marginal user's opportunity cost. This could markedly exceed the supplier's average cost for all units supplied to rush hour users. During such periods, the present value of the provider's cash flows may be well above book value.

Road providers that can sustain multi-tier tariffs may be able to better cope with capacity fluctuations than providers of services that do not provide this flexibility. Road providers, for example, may be able to charge separately for use and for access, as can membership-based golf and tennis clubs. Hotel operators can typically charge only for use. This may make it relatively easy for road operators to adopt flexible use-related prices, once billing technologies permit them to do so. If, say, 40 percent of road costs are not use-related, the average cost of access is a significant proportion of avoidable repair and maintenance costs. At first, the marginal cost of giving another representative user access to the road network would appear to be very low. However, when a flood has wiped out a bridge or a section of a road in a remote area, the marginal cost of restoring access may be quite high on a per user basis. One option here would be for the provider to bundle an insurance policy with a road maintenance contract in any annual access fee. Each user's annual access charge would then reflect the expected costs of flood-related damage on the relevant routes rather than the actual costs. For a given road quality, the premium element would obviously be higher for infrequently used roads in geographically unstable regions. Users' willingness to pay this premium would be a critical determinant of the desirability of repairing such damage.

If the road operator's revenue only covers outgoings in repairs and maintenance plus 'required' capital works, the implied capital value of the road network in its existing use is zero. In this case, consideration should be given to devoting road assets to an alternative use if they have one. Arguably most roads do not have an economic alternative use because of the costs of undoing the road bed structure.

The assessed value of the net cash flows likely to accrue to a commercial network operator will also depend markedly on central government decisions concerning the operator's ability to access revenues from taxes on road users and to set access and use charges subject only to the provisions of the Commerce Act 1986. This point highlights the arbitrariness of any assessed asset values in current circumstances.

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE DRAFT AUCKLAND REGIONAL LAND TRANSPORT STRATEGY

SEPTEMBER 1998

SUBMISSION ON DRAFT AUCKLAND REGIONAL LAND TRANSPORT STRATEGY

1 Overview

1.1 This submission on the draft *Auckland Regional Land Transport Strategy* (the Transport Strategy), prepared by the Auckland Regional Land Transport Committee (the Committee), is presented by the New Zealand Business Roundtable. The purpose of the Business Roundtable is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 The submission examines road pricing and the options for the next harbour crossing against the background of *Auckland: A Dynamic Region, A Draft Regional Growth Strategy to 2050* (the Growth Strategy) proposed by the Auckland Regional Growth Forum (the Forum), the objectives of the Transport Strategy and the emphasis placed on passenger transport.

1.3 The Committee's examination of transport issues should start from the presumption that it should be acting in the wider community interest, clearly distinguishing this from the perceived interests of non-motorists and other special interest groups. To the extent that the Committee has (or its members have) jurisdiction, it should establish a regulatory environment that leads to the provision of transport services, including private motor vehicle and passenger transport, that meets the needs of people where it is economic to do so.

1.4 The Transport Strategy acknowledges that traffic congestion imposes a major cost on individuals and firms, supports road pricing and accepts that the capacity of the roading network needs to be expanded to meet rising demand. On the other hand, the Transport Strategy endorses constraints on urban development to achieve misconceived transport goals, advocates policies that reflect inter-modal biases and places undue emphasis on passenger transport. The Transport Strategy's discussion of the next harbour crossing ignores the likely adoption of a commercial model for the operation of roads which would place prime responsibility for deciding among investment options on the road operator.

1.5 The balance of this submission is presented in four sections. The next section (Section 2) discusses the analytical approach. Section 3 examines the Growth Strategy. The proposed Transport Strategy is discussed in Section 4. The conclusions are presented in Section 5.

2 Analytical approach

2.1 The key criteria to be applied in assessing government policy are efficiency and equity. The efficiency criterion measures the extent to which resources are being used to maximise overall community well-being. The application of the criterion does not necessarily lead to high levels of measured output such as gross domestic product (GDP) or to low levels of car or fuel use. The relevant test is whether resources are used to produce high and growing levels of individual satisfaction or welfare. Hartley observed that:

> The … appeal of efficiency as a social goal is that an inefficient allocation of resources represents, in a sense, waste. If someone could be made

better off without making anyone else worse off, why not make the change?[1]

2.2 An allocation of resources is said to be efficient if the resources cannot be transferred to other uses to make someone better off without making anyone else worse off. If resources are committed to urban forms that are less reliant on the motor vehicle as proposed in the Growth Strategy when people would prefer low-density housing and are willing to meet the costs involved, resources would be misallocated. Too few resources would be allocated to the supply of low-density housing, roads, motor vehicles and fuels, and too many resources would be devoted to high-density housing and other land uses such as farming.

2.3 Productive efficiency exists when it is not possible to produce more of any product or service that contributes to an individual's satisfaction without reducing the production of another good or service. At the level of a firm, for instance a road construction business, productive efficiency requires the adoption of least cost methods of production. Regulatory arrangements that prevent firms from minimising their costs without generating a commensurate community benefit are inconsistent with productive efficiency.

2.4 If allocative and productive efficiency are broadly defined they lead to dynamic efficiency. This occurs when changes in the pattern of consumption and investment over time cannot improve one person's welfare without diminishing that of another person. Dynamic efficiency is particularly important in transport where investment options, such as an additional harbour crossing, involve a long-term commitment of resources in assets that have few other uses.

2.5 In a society in which resources are scarce and one person's use of a scarce resource affects its use by another person, the equity or fairness of public and private arrangements is often a major concern. Equity is a subjective concept that can mean different things to different people. However, concepts of non-discriminatory treatment among like cases and fairness in contracting commonly command support. Much fairness in relation to uncontracted-for and sometimes illicit transfers of wealth is also about efficiency.

2.6 Indeed, many concepts of fairness are compatible with an efficiency objective. For example, the equity concept that people should generally pay for the cost to society of the resources that they consume is compatible with marginal (social) cost pricing. Concerns about undesired cross-subsidies and opportunistic behaviour may be consistent with an efficiency goal. Contractual fairness may conform with the sanctity of contracts that is likely to be desirable for efficiency reasons. Often the most efficient solution to a problem will promote healthy cooperation and competition, and reduce the likelihood of subsequent costly disputes over fairness. However, if equity and efficiency objectives are in conflict, a trade-off between them is required.

2.7 The principle of horizontal equity requires that people in like circumstances be treated the same. The provision of variable levels of subsidy for people in similar circumstances, depending on whether they use private motor vehicles or passenger transport, are inconsistent with the principle of horizontal equity. Vertical equity recognises that variations in individual welfare justify differential treatment with the objective of reducing inequalities. It is often argued that people who earn higher incomes should generally pay more than others toward the cost of tax-financed services but not that wealthier people should pay more for goods and services.

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1 Hartley, Peter (1997), *Conservation Strategies for New Zealand*, New Zealand Business Roundtable, Wellington.

2.8 The principles of horizontal and vertical equity do not specify the extent to which poor and well-off people should contribute to government services or receive government support. Equity should generally be assessed over a person's life rather than at a point in time. The use of subsidised passenger transport by the children of well-off families is unlikely to improve equity. In addition, differences in individual welfare are impossible to measure. Policies therefore tend to focus on partial indicators of welfare such as income, consumption or wealth.

2.9 Concerns about inadequate income extend to insufficient food, shelter, clothing, education and health and transport services. A piecemeal approach to income inadequacy by central and local government is likely to create inequities and inefficiencies. In our view the tax and welfare systems are generally more efficient instruments for addressing problems associated with income inadequacy than industry-specific measures.[2]

2.10 A further concept of equity is that individuals should be afforded fair opportunities. People who hold this view emphasise access to government services rather than a strict equality of outcomes which is rarely advocated. Most people recognise that ability, personal characteristics and cultural preferences are not the same and that the attainment of equal outcomes would be a very costly goal, if it were feasible. Another aspect of equity is the view that government processes should be seen to be fair.

2.11 The equity criterion is less precisely defined than that of efficiency because people hold varying views on equity. Government agencies are nonetheless required to determine whether particular policies, including changes to them, are equitable. Equity issues primarily arise in the Transport Strategy in relation to the provision and subsidisation of transport.

3 The Growth Strategy

3.1 The publicity surrounding the Growth Strategy may mislead people into believing that the expected rate of population growth in the Auckland region is forecast at historically high levels. This may bias their assessment of the Growth Strategy and wrongly suggest that urgent decisions are required. The projections contained in the Growth Strategy suggest that the annual average rate of population growth will be between 0.64 and 1.25 percent from 1997 to 2050. By the standards of the 1960s this is a slow rate of growth and should be able to be accommodated without creating unanticipated pressures on infrastructure.

3.2 The persistent problem of inadequate infrastructure lies with the failure of political decision-making rather than unforseen demand. A host of privately provided services, such as telecommunications services, building work, vehicle repair and food production and distribution are not in short supply. On the other hand, some services that are subject to political control, such as water, stormwater and sewage services, and roads and schools are subject to frequent quantity and quality problems.

3.3 The Transport Strategy states (at page 5) that:

> The Strategy is the start ... of developing a different transport future, one that forms part of the Growth Strategy proposals to accommodate a large part of the growth through intensification around nodes and transport corridors.

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2 A similar view is advocated by Hunt, Alister (1998), *Economic Analysis of Auckland Public Transport Concessionary Fare Schemes*, a report commissioned by the Auckland Regional Council, Centre for Research in Public Management, the University of Auckland, Auckland.

Consultations on the Growth Strategy are the main process for examining whether it is appropriate. While the Growth and Transport Strategies are inter-related, the former should be finalised before the Transport Strategy is completed as the latter should be consistent with the former.

3.4 The above quotation implies that the Growth Strategy is the first to promote urban intensification and passenger transport. This is arguable. We understand that broadly similar ideas were advocated in a report prepared by F W O Jones for the Auckland Regional Planning Authority in 1961. The Forum's report, *A Place Sought by Many,* notes that urban consolidation was promoted in the Auckland Regional Authority's 1968 report, *Development in the Auckland Region*.

3.5 The Business Roundtable's initial investigations suggest that the Growth Strategy is unlikely to advance community welfare. The Growth Strategy is predicated on the idea that the outward expansion of the Auckland urban area should be limited to protect the natural environment, especially the coast. This proposition is questionable for the following reasons.

- There are no indications that large numbers of people want to live in high-density housing in the designated areas. The value which people place on development options should be a key consideration. However, government agencies are poorly placed to make informed judgments about peoples' preferences because they have no reliable way of measuring them. It is only in situations where people face actual choices that their preferences are revealed and only when people decide to exchange one thing for another (for example an amount of money for, say, a rural property) that relative weights can be properly assigned to their preferences.

  People may state that they oppose urban expansion but most contribute to it by choosing to live in low-density housing. This is a much better indicator of their real preferences than opinion polls and town hall meetings. Moreover, a high-density development model was rejected in 1975 because it failed to gain community support. Infill housing, which could be expected to accelerate with the Growth Strategy despite the stated intention to put less emphasis on it, led to strong opposition, particularly in the eastern suburbs of Auckland City and in North Shore City.

- There are no economic grounds for preserving farm and other land beyond the present metropolitan limits that has a higher value to the community for housing. The Business Roundtable understands that the protection of farm land is no longer accepted by the Auckland Regional Council (ARC) as a valid policy objective. This understanding arises from correspondence and discussions with the chair of the ARC, Mr Philip Warren, before the release of the Growth Strategy.[3] However, the limitation of so-called 'urban sprawl' is a key objective of the Growth Strategy. The conversion of farm land to urban uses is described as "a problem" in *Growth Management: A Tool Box of Techniques*.[4] The proposition that so-called urban sprawl should be "severely curtailed by requiring compact urban development patterns" is a central feature of growth management policies, which have their origin in the United States and which the Forum advocates.[5] Councillor Paterson commented at a

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3 Letter from Mr Philip Warren, chair, Auckland Regional Council, to R L Kerr, executive director, New Zealand Business Roundtable, dated 25 August, 1997 and Mr Kerr's reply of 22 December, 1997. This correspondence is available on request.

4 Auckland Regional Growth Forum (1997), *Growth Management: A Tool Box of Techniques*, Auckland Regional Growth Forum, Auckland.

5 DeGrove, John M and Miness, Deborah A (1992), *Planning and Growth Management in the States: The New Frontier for Land Policy*, Lincoln Institute of Land Policy, Cambridge, Massachusetts.

seminar on 7 August, 1998 that the Growth Strategy draws a line on urban sprawl.

The purpose of the Resource Management Act 1991 (the Act) is to promote the sustainable management of natural and physical resources. Sustainable management is defined as development that meets the needs of the present generation without compromising the ability of future generations to satisfy their needs. Instead of prescribing activities that may be permitted, the Act places emphasis on the effect that a proposed activity may have on the environment. Thus the objective of "protecting the region's environment" appears to be expressed in too absolute a form given the effects orientation of the Act. We understand from the correspondence and discussions with the ARC referred to above that it accepts that concepts such as 'urban sprawl' and 'containment' are a hangover from previous planning legislation and are inconsistent with an effects-based approach to resource management issues. Furthermore, proposals to conserve energy, other resource consumption and farm land on sustainable management grounds would not withstand close scrutiny. Given that fossil fuels are defined as minerals under New Zealand legislation, preserving fossil fuels is not a matter for consideration by local government, a point the minister for the environment has made on several occasions. Owen McShane's report, *Land Use Control Under the Resource Management Act,* discusses these issues.[6]

While there may be valid grounds for restricting urban development in some areas, for instance on environmental grounds, the case for constraining urban expansion generally is weak, and will ultimately be unsustainable. At some point the metropolitan limits will need to be moved outward if Auckland's population continues to grow.

- A reduction in road use through intensification and the encouragement of greater reliance on public transport are not necessarily valid public policy goals. These goals are inefficient where people would obtain greater satisfaction from living elsewhere and are prepared to bear the private and social costs involved.[7] If people were expected to choose voluntarily to live in high-density housing, and to use and pay for public transport, many of the proposals contained in the Growth and Transport Strategies would be unnecessary.

  Although efficient road pricing can be expected to be implemented well within in the relevant planning period (the next 50 years), the Growth Strategy focuses on the application of central controls to reduce transport use. Furthermore, intensification can be expected to add to traffic congestion unless road capacity is expanded to satisfy higher demand. The Transport Strategy reports that commuter patronage of mass passenger transport services has declined since 1986 and is small. This trend is not surprising, given rising incomes, a reduction in the real price of travel by private motor vehicle and changes in employment levels within the central business district (CBD), and is apparent in other countries.[8]

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6 McShane, Owen (1998), *Land Use Control Under the Resource Management Act: A 'Think Piece'*, a report commissioned by the minister for the environment, Ministry for the Environment, Wellington.

7 The attainment of values which were ranked relatively highly in the 1997 DigiPoll such as employment, economic opportunities, and friends and family rely heavily on personal transport rather than passenger transport whereas a sense of community was ranked 15 out of 16.

8 See 'Survey on Commuting', *The Economist*, 5 September, 1998.

Passenger services are unlikely to play a major role in Auckland because of its relatively low population density. A massive change in preferences would be required before such services would significantly affect private motor vehicle use. Evidence from overseas cities, that have allowed congestion to develop, suggests that most private motorists will prefer to use their cars even at average peak hour speeds of 10 kilometres an hour. The Business Roundtable is not aware of any information which suggests that a change in preferences is likely in the medium term and this appears to be recognised by the Transport Strategy at the top of page 29.

- The studies prepared for the Forum show that the cost of providing infrastructure for higher-density housing is not significantly lower than for low-density housing. The Business Roundtable understands that sewage and stormwater services on the isthmus were broadly designed to service single houses located on sections of about $600m^2$. They are reported to be close to capacity. High-density housing would require such services to be expanded and the cost saving compared with a green field development is reported to be within the margin of error. More importantly, the key issue is not one of controlling where people live in a partial and fruitless effort to contain the cost of selected services but of introducing market mechanisms for the supply of affected services so that people can make their choices in the light of the costs involved.

- The members of the Forum do not have power to require the Growth Strategy to be implemented. The Local Government Amendment Act 1998 does not give the Forum or the ARC such power, although projects that are funded by Infrastructure Auckland cannot be inconsistent with the Growth Strategy. The ARC may be able to require territorial local authorities to alter their district plans to permit high-density housing in residential areas but that will not produce such housing unless homeowners and renters are prepared to buy or rent such housing. It can also attempt to induce people to live in high-density housing by artificially constraining the supply of other forms of housing, for instance by holding the metropolitan urban limits, thereby making low-density housing expensive. However, unless the public supports such a policy, it will prove to be unsustainable in the medium term.

  The Growth Strategy recognises that with intensification house prices would be higher than otherwise. This acknowledgment seems to be an about-face by the ARC and other councils that previously dismissed Owen McShane's view that restrictions on the supply of land for urban development were putting upward pressure on house prices.[9] Policy-induced increases in house prices lead to higher interest rates and distort consumption and investment patterns. The policy would adversely affect housing options available to people, particularly those on low incomes and with few resources, and is inequitable. It could be expected to accentuate overcrowding and reliance on accommodation provided by caravans and garages.

3.6 For these reasons, the Growth Strategy provides an unsound basis for the Transport Strategy. In particular, the emphasis placed on urban intensification and reliance on passenger transport services is mistaken and should be reconsidered by the Forum.

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9 McShane, Owen (1996), *The Impact of the Resource Management Act on the 'Housing and Construction' Components of the Consumer Price Index: A 'Think Piece'*, a report prepared for the Reserve Bank of New Zealand, Reserve Bank of New Zealand, Wellington and Cooper, Adrienne Young and Hill, David (1996), *A Local Authority Response to the McShane Report*, a report commissioned by the Auckland Regional Council, Auckland City Council, Franklin District Council, Manukau City Council, North Shore City Council, Rodney District Council and Waitakere City Council, Hill Young Cooper Ltd, Newmarket.

The proposed regional land transport strategy

4.1 The goal

4.1.1 The goal of the Transport Strategy is to achieve:

> A safe, efficient and environmentally sustainable transport system for the Auckland region which meets the community's accessibility needs at reasonable cost.

There are several problems with this goal. It is not realistic to set a goal that implies an absolutely safe transport system because an absolute standard of safety is unachievable. Society faces a trade-off between the level of resources committed to the pursuit of safety and to other goals, as noted on page 9 of the Transport Strategy. A speed limit of, say, 10 kilometres an hour would result in fewer traffic accidents and deaths and less serious injuries, but would still not be safe. Furthermore, the cost in terms of longer travel times and higher investment in roads would be substantial. The relevant issue for public policy, therefore, is the achievement of an optimal level of safety, that is, where the marginal return to the community from investing an additional dollar in reducing or mitigating road accidents is one dollar. A similar problem arises in respect of an environmentally sustainable transport system. The extent to which resources are devoted to the achievement of environmental goals and the cost of the system are all efficiency issues.

4.1.2 The Transport Strategy should focus on the maximisation of community welfare. To the extent that they have jurisdiction, the members of the Committee should encourage the establishment of a transport system that makes the largest possible contribution to community welfare. This goal recognises that trade-offs must be made between safety, environmental, mobility and other objectives with the overriding objective of providing the highest possible level of community welfare.

4.1.3 Central and local government have the role of establishing the rules within which people and firms interact. Most decisions are, however, properly taken by individuals in a free society. Many of the policies outlined in Appendix D of the Transport Strategy reflect poorly defined objectives, capture by special- interest groups, undue emphasis on environmental issues and a heavy-handed planning approach. Proposed policies relating to the management of parking and support for measures that will result in fewer and shorter vehicle trips are examples. Councils have no valid role in researching, advocating or promoting flexible working hours, teleworking or peak spreading. The planned investigation of such options reflects an inability to define clearly the proper role of government.

4.1.4 A key weakness of the Transport Strategy is the absence of a commitment to the principle of competitive neutrality among transport modes – bus, train, car, taxi, bicycle, ferry and pedestrian traffic. Neutrality is important for optimal resource allocation and would appear to be entirely consistent with the requirements for a regional land transport strategy set out in section 29F of the Land Transport Act 1993. (We acknowledge that section 32 of the Transit New Zealand Act 1989 requires regional councils to consider the transport needs of the 'transport disadvantaged' in preparing their funding programmes.) An implicit aim of the Transport Strategy is to penalise private motoring (by imposing costs beyond the private and external costs involved) while encouraging certain forms of passenger transport, walking and cycling. Neither walkers nor cyclists bear the costs that they impose on other road users and they are not necessarily disadvantaged.

4.1.5 The reforms under study by the government envisage the adoption of a commercial model for the operation of roads. The government has indicated that roads will remain in public ownership. Government ownership of roads suffers from two key weaknesses. The first is that optimal investment in roads may not take place. The second is that the existing infrastructure may not be operated as efficiently as possible. Better ownership arrangements are required to improve the efficiency of roading. For example, the implementation of efficient road pricing, particularly taking account of congestion, is likely to be difficult with the present ownership structure. Similarly, a separation of regulatory and ownership roles, as would occur with a commercial model, would lead to better decision making.

4.1.6 The Transport Strategy barely touches on the likely adoption of a commercial model for the operation of roads but it asserts that its goals, objectives, policies and methods are expected to be relevant to whatever organisations are put in place to deliver roading and other transport outcomes. This is unlikely. The adoption of a commercial model would, over time, lead to the abandonment of the command and control approach that is reflected in the Transport Strategy. A commercial road operator, for instance, could be expected to decide among options for the next harbour crossing and then seek any consents that are necessary in terms of the Resource Management Act 1991. The move to a commercial model should be endorsed in the Transport Strategy.

4.2 Road pricing

4.2.1 Encouragingly, road pricing is "strongly supported" by the Transport Strategy "as a means of managing demand, relating road use more directly to its costs, raising funds for network expansion and avoiding, remedying or mitigating environmental effects". The Transport Strategy notes, however, that "there are many uncertainties concerning the ability to introduce road pricing, the way it is introduced, its acceptability and effects". The Transport Strategy states that roading pricing will not be in place for the next five years.

4.2.2 We endorse the Transport Strategy's support for the principle of road pricing. The Business Roundtable has long advocated more efficient road pricing and the case for it was set out at length in a 1993 report, *Options for the Reform of Roading in New Zealand*, prepared by CS First Boston New Zealand Limited.[10] Direct charges would enable road operators to determine the preferences of users relating to congestion, safety, surface quality and other matters, and would lead to better investment decisions.

4.2.3 The technology required to implement road pricing is advanced. More efficient road pricing, such as area licensing and tolls on the harbour bridge, should be under consideration now and should be an important feature of the Transport Strategy. Furthermore, the discussion of road pricing contained in the Transport Strategy is imprecise. It is unclear, for example, who would set road prices and how the revenue would be used. As in other industries, the road operator should set charges and the revenue should be used to fund the operator's operating and capital costs. The Transport Strategy also implies that many environmental and other external costs would be included in road prices. However, as noted in the Land Transport Pricing Study[11], many possible external costs are too imprecise and uncertain to justify their inclusion in road prices. The standard test of whether the benefits of government action outweigh related costs should be applied. Many of the issues to be addressed in implementing road pricing, for example the implications (if any) of network externalities, apply to other regions, particularly Wellington. There would, therefore, be advantages in advancing road pricing on a national basis.

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10 *Options for the Reform of Roading in New Zealand*, New Zealand Business Roundtable, Wellington.

11 *Options for the Future: Land Transport Pricing Study*, Discussion Document, Ministry of Transport, May 1997.

4.2.4 The view that a reasonable alternative to motor vehicle use should be available before road pricing is introduced is mistaken. Efficient road pricing may encourage the development of services that compete with private motor vehicles. The provision of passenger transport services such as bus, train, taxi and ferry services is a private activity. Private providers should determine whether alternative services are likely to be economic with road pricing. The main possible concern with road pricing is one of affordability which is discussed below.

4.2.5 An issue that arises is the optimal level of charges levied on users of the road network pending a move to direct road pricing. Currently road users pay much more than is spent on the roads by central and local government combined. The fact that central government rations the funds it collects from road users and passes them on to local government does not justify requiring road users to pay more to make up the deficiency. It is currently central government's responsibility to ensure that road use charges – through petrol taxes, road user charges and licence and registration fees – are optimal from a user-pays efficiency perspective. However, congestion charges may improve efficiency and allow some adjustments in other charges. Sub-optimal outcomes would occur if local government attempted to recover any funding deficiency by adding to those charges – in that situation an element of double charging would fall on road users. Rather than distort inter-modal pricing signals in this way, it might be more efficient for local government to cover such a deficiency from rates. This is an optimal taxation issue which would require careful analysis.

4.3 Passenger transport

4.3.1 The thrust of the Transport Strategy is to stimulate demand for passenger transport by intensifying urban development around existing rail corridors, funding passenger transport infrastructure, implementing bus priority measures, creating bus-only lanes and adopting traffic restraint policies. These policies, aside from efficient road pricing, prejudge user preferences and conflict with the principle of neutrality. Moreover, the provision of passenger transport services such as park and ride facilities and rail stations are activities that should be privately provided and funded.

4.3.2 A main argument advanced in the Transport Strategy for subsidising passenger services is to reduce road congestion. When road congestion is a problem two things should happen. First, if it is commercially practicable, congestion pricing should apply for all peak-time road users, including bus operators. Bus operators should be charged for the opportunity cost of any bus-only lanes. Such costs would ultimately be borne by bus patrons. Congestion tolls should apply to all users. Secondly, more road capacity should be built when the benefits from doing so exceed the costs. Where peak-time traffic volumes are too great because roads are under-priced at peak times, providing capacity too early to ease that congestion could be uneconomic. However, in principle these issues should be taken into account in Transfund's cost-benefit analyses of capital expenditures.

4.3.3 As a general rule there is no sound case for subsidising alternatives to car use taken by those who choose to go to a restaurant, the beach, the supermarket or anywhere else at peak times. Taxis, buses, trains, motorbikes, bicycles, walking, mail-order shopping and communication over the telephone may be alternatives to the use of a private car. How close people choose to live to shops, schools and their place of work also affects their choice of transport mode.

4.3.4 A sceptical view should be taken of the contribution that bus and rail services can make to reduced congestion. Car-clogged roads would disrupt bus schedules and feeder routes for people who travel by train. With economic growth it is only a matter of time before new road capacity would be required. Once provided, any case for bus and train subsidies to ease congestion would disappear. Winding back an over-expanded bus and train system could be painful. As traffic volumes grew, congestion would eventually reappear, but in this timeframe electronic pricing (charging for road use by electronic means such as vehicle transponders) is likely to provide a superior solution to the problem.

4.3.5 Subsidies for passenger transport services are not typically directed solely to peak-time travellers who use buses or trains rather than cars. Instead they fund bus and train services for less well-patronised routes at off-peak hours. The Transport Strategy supports the Britomart project and subsidies to upgrade rail stations. Such proposals have little to do with easing peak-load congestion problems on major roads and more to do with the provision of subsidised mass passenger transport services.

4.3.6 Subsidies for peak-time use of buses and trains will generally be inefficient where direct pricing for road usage, including congestion costs, is feasible. They could lead to over-crowding on buses and trains during peak periods, or to the over-provision of bus and train capacity. Alternatively, the diversion of peak demand could see the imposition of opportunity-cost-based peak-time prices on buses and trains. The public would complain that this was self-defeating in terms of the Transport Strategy's objective of reducing road use by motorists and there might be a public outcry about the contribution of the subsidy and peak-time pricing to the profits of rail and bus providers.

4.3.7 A report, *Alternative Transport Infrastructure Investments and Economic Development for the Auckland Region*, prepared by Ernst & Young[12], concluded that public passenger transport is more efficient than car-based investments. However, such an analysis cannot hope accurately to determine the value individuals put on the mobility, privacy and flexibility benefits provided by a private motor vehicle. Its conclusion appears to be based on a faulty analysis. The study made the error of including excise taxes, which are a transfer and not a resource cost, as a social cost of operating motor vehicles. Doubtful estimates of external costs were also taken into account. For instance, $525 million was included for the external cost of accidents when such costs are largely borne by motorists through insurance arrangements. A cost of $120 million was included for energy externalities (in addition to pollution costs) when there are no sound grounds for believing that motorists do not bear the resource cost of the fuels that they use. The Business Roundtable suspects that a valid analysis would support the opposite conclusion and believes that policy should be neutral across modes, allowing users to make undistorted choices.

4.3.8 An equity argument is also advanced for mass passenger services. The Transport Strategy notes that about 11 percent of households do not own a motor car. The Transport Strategy aims to provide mobility for the young, the elderly, people with disabilities, and for people who cannot afford a motor car. The advocacy of subsidised passenger services on these grounds is weak and arguably conflicts with the grounds advanced for subsidising bus services for all users. The responsibility of providing mobility for the young rests with their parents, most of whom are able to provide or fund their children's transport. Children may be able walk, cycle or change their activities to avoid the need to use passenger transport. The essential issue for the remaining groups is whether people can afford to own a car or to meet the unsubsidised cost of services provided by taxis, buses, trains and rental cars.

4.3.9 The main problem is not the absence of transport services but their cost relative to people's income and other spending priorities. (Note that taxi services are available on a 24 hour a day, point-to-point basis and that other services would emerge where

12 Ernst & Young (undated), *Alternative Transport Infrastructure Investments and Economic Development for the Auckland Region*, unpublished report prepared for the Keep Auckland Moving Campaign, Ernst & Young, Auckland.

economic in the absence of licensing.) This is a pervasive problem. It explains why people on low incomes consume fewer goods and services than other people. To the extent that government action is justified, direct income transfers rather than the subsidised supply of goods and services are generally preferred because they enable the recipient to maximise their welfare for a given level of income. Responsibility for redistributing income rests with central government in New Zealand. Local authorities do not have legislative authority to make direct income transfers. The provision of provider subsidies for bus or train services is an inefficient way of addressing an affordability problem because such subsidies are poorly targeted and they bias the choice of transport mode.

4.3.10 While the Transport Strategy does not provide a definitive view on the merits of light rail systems, it has been interpreted by some interest groups as indicating that such an option is unattractive. A number of councillors in the Auckland region continue to promote a light rail scheme. We are not aware of any respected international research which suggests that such a proposal would be economic for a city of Auckland's size and geography. If a light rail scheme were viable without subsidies, the private sector would undertake it.

4.4 Expansion of the road network

4.4.1 The Transport Strategy identifies the capacity limit on the harbour bridge as a major constraint. Options for an additional harbour crossing are discussed in the Transport Strategy.

4.4.2 The discussion of the next harbour crossing is set in the context of the present operating structure of roads which is expected to be replaced by the adoption of a commercial model. The prime responsibility for deciding roading investments within a commercial model would rest with the road operator. The adoption of a commercial model is intended to establish a regulatory environment that encourages road operators to take decisions which are optimal. The operator would be required to obtain the necessary consents under the Resource Management Act 1991.

4.4.3 There is far too little information available in the Transport Strategy to enable an informed view to be reached on the options presented if the existing institutional structure for roading is assumed. However, some key factors that would need to be taken into account in weighing up the options available are listed below.

- Given the extraordinary delays involved in obtaining approvals for major projects, present roading agencies should take the steps necessary to enable additional road capacity to be provided when it is economic to do so. From this perspective, the initial discussion in the Transport Strategy is a helpful step.

- Investment in roads or other transport services that represents a good use of resources from a community perspective should proceed. Equally, investment proposals that are not economic should be delayed or dropped.

- The implementation of more efficient road pricing should be a key factor in evaluating any major investment in roads. Projects which users are unlikely to be willing to pay for should not proceed.

- The principle of neutrality among transport modes should be adopted. There are no grounds for favouring mass passenger transport relative to private motor vehicles.

- The scope to improve the productivity of the existing road network should be explored. Measures such as the creation of dedicated bus lanes that are advocated in the Transport Strategy may well reduce effective road capacity. Peak-time pricing of existing roads, such as the harbour bridge, are an important step in this regard and should be considered for implementation in the near term.

- The Transport Strategy states that the "issue is whether the accessibility benefits of constructing an additional harbour crossing outweigh the costs of the project". The issue is much broader than this as the Transport Strategy notes on pages 33 and 34. The capacity of the harbour bridge is not the key constraint. There are more lanes on the bridge than on the approaches to it. The relevant issue is whether the capacity of the North-South corridor through the region should be increased. Another harbour crossing is only one link in such a corridor and cannot be considered in isolation.

- New investment should, within the present institutional arrangements, properly take account of capital and current costs and be based on a sound analysis from a community perspective. The costs identified in the Transport Strategy are understood to reflect capital costs only.

4.4.4 An argument is sometimes advanced that the construction of more roads simply means more traffic. One implication of this view is that it is not possible to satisfy demand. It would be bizarre to encounter the argument in the electricity, telecommunications, water or any other network system that new capacity should not be built to accommodate demand. The implication would be that, with rising demand, users should have to put up with power-cuts, persistent 'busy-signals' or a loss of water pressure. The principle is inconsistent with the objective of maximising the welfare of ratepayers and citizens of the region.

5 Conclusion

5.1 The Transport Strategy's stated goal fails to identify adequately the problem or problems that it seeks to address, largely ignores the scarcity of resources and prejudges community preferences. An alternative approach would be to state that the goal of the Transport Strategy is to address coordination problems that arise from diverse public ownership of the roads servicing the Auckland region in respect of regulation, pricing and provision, with a view to maximising overall community welfare. This approach recognises that trade-offs must be made between safety, environmental, mobility and other goals with the overriding objective of providing the highest possible level of community welfare.

5.2 The Transport Strategy has been prepared in the context of the Growth Strategy. The Growth Strategy's emphasis on urban intensification and passenger transport services is mistaken and should be reconsidered. Moreover, the Growth Strategy should be finalised before the Transport Strategy is completed as the latter should be consistent with the former.

5.3 The Transport Strategy lists five objectives as desired outcomes (pages 26–27) but does not identify the problems that are stopping existing providers or regulators from achieving those objectives. Nor does the Transport Strategy identify who is responsible for the achievement of the objectives, how their performance is to be measured or how they are to be held accountable for their achievement. Although the detailed policies and methods set out in Appendix D of the Transport Strategy identify the responsible parties, many policies are the responsibility of multiple parties thereby making accountability difficult. This problem is accentuated by the absence of performance measures. Several of the objectives appear to be either redundant or in conflict with the efficiency objective, but no guidance is provided as to how such conflicts are to be resolved.

5.4 A key requirement in terms of the efficiency objective would be to confront users and residents with the costs of their location and transport choices. This implies a commitment to competitive neutrality across modes and the absence of preferences for any groups. An efficient policy would not seek to impose outcomes in terms of location choices, housing densities or type of transport. Instead it would aim to put in place efficient pricing and regulatory arrangements. Collective outcomes would result from the diverse and autonomous decisions of individuals. A key weakness of the Transport Strategy is the absence of a commitment to the principle of competitive neutrality among transport modes – bus, train, car, taxi, bicycle, ferry and pedestrian traffic. Neutrality is important for optimal resource allocation.

5.5 The reforms under study by the government envisage the adoption of a commercial model for the operation of the road network. The Transport Strategy barely touches on this aspect of the road reforms. The adoption of a commercial model would, over time, lead to the abandonment of the command and control approach that is reflected in the Transport Strategy. The policies advocated in the Transport Strategy should take account of the adoption of a commercial model and the move to such a model should be endorsed.

5.6 The Transport Strategy's support for the principle of road pricing is endorsed but more evidence of action is required. Options should be presented, impediments identified and a timetable for addressing problems should be adopted. A plan for implementing more efficient road pricing should be a key feature of the Transport Strategy.

5.7 The thrust of the Transport Strategy is to stimulate demand for passenger transport by intensifying urban development around existing rail corridors, funding passenger transport infrastructure, implementing bus priority measures, creating bus-only lanes and adopting traffic restraint policies. These policies, aside from efficient road pricing, conflict with the principle of neutrality. As a general rule there is no sound case for subsidising alternatives to car use at peak times.

5.8 The Transport Strategy identifies the capacity of the harbour bridge as a major constraint and raises options for expanding it. The approach ignores the likely adoption of a commercial model for roading. The prime responsibility for deciding investment in roads with a commercial model would rest with the road operator. The adoption of a commercial model is intended to establish a regulatory environment that encourages road operators to take decisions which are optimal from the community's perspective.

IIR CONFERENCE ON OWNERSHIP, MANAGEMENT AND FUNDING OF INFRASTRUCTURE ASSETS

THE ARST FIASCO: FULL CIRCLE TO NOWHERE

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AUCKLAND
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THE ARST FIASCO: FULL CIRCLE TO NOWHERE

Barely a week passes without the community being reminded of the costs of erratic policy directions as yet another reform initiative falters. This is plainly evident in the government's attempts at microeconomic reform, including efforts to get central and local government out of owning commercial businesses. The latest debacle has been the about-turn by the Wellington City Council, having committed itself to a sale process, on the small and geographically challenged Wellington airport, and the labyrinthine path followed by the government in deciding to dispose of its own shareholding. Apparently a crucial factor in the Council's case was the decision of one councillor who drives a Wellington bus. On the fateful day he reported that he had listened to what the passengers were saying, decided the mood was against a sale, and thus opposed it. As one analyst remarked, "Pity he was on the Karori run and not Wadestown". Yet leading local government politicians still have the gall to claim they can run businesses as competently as private owners.

The previous similar example of policy meltdown was the creation of Infrastructure Auckland.

This saga is salutary for several reasons. Infrastructure Auckland replaces an entity that was intended to be temporary and was an anomaly in local government. Its creation followed a long and tortuous process that reflected a triumph of parochial politics over principled decision-making. Despite its name, no one is sure of its mission and to whom it is accountable. In the ensuing vacuum there has been no shortage of suggestions about how to spend money on low yielding projects. With even less tightly focused objectives than its predecessor, the siren calls for high profile, politically popular but commercially wasteful projects will come thick and fast.

Furthermore, to the extent that Infrastructure Auckland does anything at all, it is likely to impede worthwhile reforms in other areas, either through subsidies that mask the true resource costs of goods and services, or as a shareholder that faces weak incentives to act commercially.

It is worth spending some time analysing these outcomes and looking for lessons for the future.

Infrastructure Auckland's predecessor, the Auckland Regional Services Trust (ARST) was created by statute in 1992. It arose from a reform of the Auckland Regional Council (ARC), which had at the time accumulated debt to the tune of $224 million. The Auckland Regional Council retained its regulatory functions while the ARST was given the responsibility to manage and ultimately eliminate its debt through a programme of asset sales. In general, these moves made good sense.

The overall quality of the assets inherited by the ARST was low, reflecting the poor incentives of the Auckland Regional Council to make commercially sound investments. For example:

- Regional House was only 50 percent tenanted and had an associated debt of around $100 million. It was eventually sold for $36 million;
- the refuse transfer station at Constellation Drive cost $20 million and was sold for $4.5 million; and
- the City Bus Depot in Gaunt Street had an associated debt of $10 million with a market value of $2.5 million.

The ARST was seen as a transitional structure pending the rationalisation and sale of its assets. The assets that dominated its balance sheet were its 80 percent shareholding in Ports of Auckland Limited (POAL) and ownership of Watercare Services Limited (WSL), Transportation Auckland Corporation Limited (TACL), Northern Disposal Systems Limited and Regional Forests Limited.

The ARST had a relatively tight focus. It was required to apply its revenue to meet its costs, to reduce its debt (where appropriate and consistent with its functions) and, subject to other priorities and at its discretion, to pay any surplus revenue to a Community Trust. Because it did not think the Community Trust would spend money wisely, however, it paid over only minimal amounts.

With its relatively clear commercial focus, a favourable economic environment and the benefits of port reform, including substantial capital distributions by Ports of Auckland, it is unsurprising that the ARST managed to repay its debt ahead of schedule. Only those who did not understand the inefficiency of ARC and harbour board management and the benefits of commercialisation regarded this achievement as a miracle. But, having repaid its debts and being unwilling to commit funds to the Community Trust, the ARST started to have second thoughts about its future. The notion that it was intended to be a temporary structure also began to recede in the minds of other local body politicians.

Self-servingly, the ARST started to talk up problems about Auckland's infrastructure 'crisis' and the need for a funding agency to address and coordinate infrastructure needs. Cost estimates for funding necessary infrastructure of upwards of $6 billion were bandied about. A study was funded by the ARST that proposed its replacement by an Infrastructure Bank. By the time the government published its discussion document *Pathways for Auckland* in mid-1997, infrastructure had become the central issue in considering the ARST's future.

Conveniently overlooked in the debate was the fact that Auckland is currently growing at a slower rate than in the 1960s. When pressed to be more specific, infrastructure needs of between roughly $2 billion and $4 billion were asserted by the ARC and Auckland local authorities, and these figures represented undiscounted costs over 20 years – hardly the stuff of an infrastructure funding 'crisis'.[1]

But talking up an infrastructure crisis had served the purpose of obfuscating the debate about the future of the ARST. *Pathways for Auckland* set the scene for the ensuing struggle between competing local body interests that wanted to grab a slice of the pie. The document raised various options which broadly provided that the ARST be retained but be given the responsibility to fund infrastructure; that its assets be distributed to territorial local authorities to fund infrastructure; that a new holding company should be set up for this purpose; or that the assets be distributed to local authorities or to local electors.

Auckland politicians vigorously resisted the idea that shares in commercial investments (other than Watercare) might be distributed to electors. The catch-cry was that distributing shares to ultimate owners would remove community control and accountability. The practical (un)reality of current community control and accountability is illustrated by the fact that only 35 percent of electors in Auckland voted at the last local body elections for the ARST, and fewer than 20 submissions on its 1997 Annual Plan were received. Voters are too busy and have too many competing priorities to invest time in selecting representatives on organisations like the ARST or monitoring their decisions.

Accordingly, community control and accountability is, in reality, the exercise of control and accountability by and to politicians. Further evidence of this is the fact that the legislation that set up Infrastructure Auckland is replete with provisions that reflect behind-the-scenes compromises and deals. Unsurprisingly, the hand of politicians has

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1 Information released under the Official Information Act 1982.

been strengthened. Accountability to the electorate will, in the future, be even weaker with members of Infrastructure Auckland appointed by, and only indirectly accountable to, an electoral college comprising local body appointees.

Political control does not necessarily promote community accountability, let alone efficient service delivery. As one observer in the United States noted in the context of the electricity industry:

> When state regulatory agencies began urging electrical utilities to encourage conservation among their customers and to develop alternative energy sources, investor-owned utilities did more than municipally-owned utilities serving comparable markets. For many years the Environmental Protection Agency had more success in getting private power generators to reduce pollution than it had in getting the Tennessee Valley Authority to do so… . [Public] agencies enjoy political protection denied to most firms.[2]

Similar results that confirm the superior efficiency and compliance of investor-owned firms have been found in other studies. For example, since private investors have helped supply water to Paris from the mid-1980s, water provision has improved dramatically. The level of unaccounted-for water dropped from 22 percent in 1987 to 12 percent in 1991. Information about the quality and condition of water supply assets has also improved dramatically.[3]

The problems with Infrastructure Auckland begin with its mandate. The principal function of Infrastructure Auckland is to provide grants to regional projects involving land transport, passenger services and operations of stormwater. The grants are restricted to projects or parts of projects that generate "benefits to the community generally in addition to any benefits that accrue to any identifiable persons or groups of persons". The idea here is to confine Infrastructure Auckland to public goods activities: services that cannot readily be provided and charged for by the private sector on a commercial basis. In addition, $10 million is to be provided to fund the arts.

However, most of the activities envisaged for Infrastructure Auckland cannot be justified on the basis of public goods criteria. Thus there is little role for a regional funding body for land transport. State highways are currently owned by Transit New Zealand, with territorial local authorities providing local roads. Reform of existing institutional arrangements, including of road pricing, offers the best prospects for ensuring that the right mix and level of investment in roading occurs. Grants by Infrastructure Auckland risk creating distortions that would result in prices not reflecting the full costs of road provision and in inappropriate investments.

Likewise, there is no compelling case for a specialist agency to fund public transport options such as light rail. Given a proper road pricing system, including congestion pricing, efficient public transport decisions would be made on normal commercial criteria.

However, the absence of a sound rationale has been no impediment to various parties suggesting ways of spending millions of Auckland ratepayers' dollars. Proposals have included a rail tunnel to Mount Eden (which briefly excited local interest), and hovercraft services on the Manukau Harbour. A hardy perennial that has been given new life by the advent of Infrastructure Auckland is the development of a light rail network. This continues to be promoted in some quarters despite the absence of any respected

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2 Wilson, James Q (1989), *Bureaucracy: What Government Agencies Do and Why They Do It*, Basic Books, New York, p 359.

3 On the successes of the French model in Paris, see World Bank, (n d), *Potential Private-Sector Participation in Lima's Water Services*, Water and Sanitation Utilities Partnership, Report No 2, p 7.

international research that shows that a light rail network would be economic for a city of Auckland's size and geography.

Auckland mayors have focused on the commercial assets of the ARST because of the potential to milk them as cash cows. Having access to a stream of income to fund projects that are attractive to lobby groups but of little other merit is a far more attractive proposition than having to justify funding them from rates and user charges.

It follows that there was no need to set up Infrastructure Auckland to deal with perceived local problems. No such structures have been found necessary in other parts of the country. The chronic infrastructure problem in Auckland today is roading, that is best dealt with by the commercial approaches that the government is promoting. Similarly, other infrastructure services like electricity, gas, airports, ports and telecommunications are best provided by commercial utilities and there is no need for either central or local government to own or operate them. This has become a widely held view. Only a dozen years ago the main infrastructure problem in Auckland was making telephone calls to the central business district. The opening of the telecommunications market to competition and the corporatisation and privatisation of Telecom solved that problem many years ago. The same lesson applies in the electricity industry: the confused governance structures of Mercury Energy did not help decision-making in the company and continue to hold it back.

It became apparent to many participants in the ARST debate as it progressed that there is no such thing as an amorphous concept of infrastructure, merely a number of specific utility businesses, all of which – including increasingly roading, water and sewerage – can be run on conventional commercial lines. By contrast, it was found that the list of genuine public goods that required non-commercial sources of funding was exceedingly short, and that standard funding mechanisms for them were already in place. As noted, public transport is not a public good and the only possible candidate of any consequence is stormwater. Where user charges or proxies for them are inefficient, public goods should be financed from taxes or rates. In this way those making decisions about their provision are directly accountable to taxpayers and ratepayers. Stormwater services have been financed in Auckland and elsewhere in this way. Using the mechanisms of Infrastructure Auckland for this purpose merely blurs public accountability for decisions.

Even within the confines of the misconceived objectives of the promoters of Infrastructure Auckland, the legislation is deficient. There is an inadequate separation between the role of Infrastructure Auckland as a funding agency and its role as a manager of commercial investments to fund its activities. Locking in an undiversified portfolio for Infrastructure Auckland dominated by Ports of Auckland exposes its funding base to risks which few prudent fund managers with Infrastructure Auckland's funding responsibilities would wish to accept. If the arguments for an infrastructure fund were sound – which they are not – logic would point to divesting disproportionately large assets in a specific geographical region and investing the proceeds in a balanced global portfolio to yield maximum returns.

What should have happened to the assets that made up the ARST? The reality is that the ARST is essentially just a holding company for a handful of businesses. The deficiencies of trusts as a governance form for capital intensive commercial operations are well known. The original plan should have been adhered to, namely that the restructured businesses should have been progressively moved to the private sector and the ARST wound up. The proceeds of the sales should have been returned to Auckland ratepayers or, alternatively, shares in some of the businesses could have been issued directly to ratepayers. All these options remain feasible and desirable.

Events began moving down that track. The ARST disposed of most of its property assets some time ago. It has now sold its bus operation to Stagecoach. In August 1998 the chair of the ARST was extolling the virtues of the sale in terms of improved services, new investment in buses and a good sale price. He did not mention that the ARST had stalled over the sale for years and had to be pushed into it by central government. Similarly, the forestry assets are on the market and the sale of the waste disposal business should be straightforward.

Essentially that leaves only the major businesses of Ports of Auckland and Watercare as well as the smaller investment in the America's Cup Village, a property investment that can be readily disposed of in due course.

Ports of Auckland was set up under the Port Companies Amendment Act in 1990. In his speech introducing the legislation into parliament, the minister of transport, Bill Jeffries, commented that the government had misgivings over continued full local government ownership of port companies. The points he made about the mismanagement of ports under local government ownership are as pertinent today as they were then:

> While the establishment of the companies has enabled commercial port operations to be isolated from the social and political baggage that harbour boards were saddled with, a strong element of the old system will remain as long as local government continues to be the main shareholder … .
>
> Wider ownership of port companies will ensure a break with traditional local government perceptions that ports can be manipulated, at a cost to users, for the supposed value of regional or local development. History has shown that this attitude has led to bad investment decisions and inefficiency … .
>
> It is time for local authorities to set aside the last vestiges of the tradition of local government control of our ports, and make their contribution to even greater port efficiency in the future by ensuring that outside investment in port companies can become a reality.[4]

The ports legislation permitted local authorities to sell their shares in the port companies. The Waikato regional council sensibly proceeded to sell its 20 percent shareholding in POAL but the ARST declined to do so. The company has benefited from partial listing. The disciplines of the sharemarket force directors and management to adopt a sharper commercial focus, and limit political interference. Nevertheless, POAL continues to be hampered by the constraints of public ownership in a number of ways. It has suffered from political infighting over the membership of its board. Public ownership and parochialism is an obstacle to rationalisation of the ports industry in New Zealand, that is necessary in response to international trends in shipping services. Capital raising constraints on new investment could be a problem at some stage, and the company is hampered in developing broader business strategies which could include, for example, involvement in the ports industry in Australia.

The sale of the government's shareholding in Auckland International Airport Limited has been accomplished successfully and with minimal controversy, and the company now has the benefit of majority private ownership. By contrast, Auckland local authorities remain inappropriate minority and majority shareholders in the airport and port companies respectively.

In the case of Watercare, the ARST deserves credit for setting up Auckland's bulk water operation as a quasi-commercial structure. It was the first major move in this direction in the New Zealand water industry, a major industry which has been lagging well behind developments in other countries. Nevertheless, the limitations of Watercare's current structure have been apparent for some time. The legislation that set up Infrastructure Auckland and transferred the assets of Watercare to territorial local authorities almost completely failed to address them:

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4 Hon W P Jeffries, speech to the North Island Waterfront Reform Seminar, 5 July, 1990.

- it failed to remove uncertainty about whether or not Watercare can charge to recover its cost of capital, thereby retaining a significant obstacle to Watercare pricing water appropriately;

- it failed to allow Watercare to pay a dividend so that it would be subject to normal commercial disciplines that promote wise investment;

- it failed to remove restrictions which impede Watercare's ability to sell major non-core assets. This will continue to prevent Watercare from rationalising its assets by freeing up cash for investment elsewhere or to repay debt or capital; and

- it entrenched ownership of Watercare by its customers which, together with the other restrictions noted, will lead to the under-pricing and wasteful use of water.

A truth that continues to elude many politicians is that Watercare, or any other entity for that matter, cannot supply services at lower cost to the community merely by not being required to achieve a profit and provide a dividend to its shareholders. Eliminating these expectations simply means that prices will not reflect the full opportunity costs of capital, incentives to control costs are weakened and principles of intergenerational equity are breached, since costs will not be recovered in the period they are incurred. Prices that permit an adequate return on capital are essential to ensure that WSL makes efficient investment decisions. The subsidy inherent in the lack of full recognition of capital costs will promote over-consumption of water and rationing by non-price means or pressure for the premature expansion of capacity. Either way, community welfare is reduced.

There is still work to be done at the national level to establish a sound, modern regulatory framework for the water and sewerage industry. But there is no reason why, within this framework, Watercare should not be placed on a standard commercial footing (like the Auckland City Council's Metrowater) and subsequently why various forms of private sector involvement, ranging from franchising to the sale or giveaway of shares, should not be considered. As in the case of ports and power companies, private ownership would facilitate the mergers and rationalisations that are badly needed in the industry.

What all this means is that the outcome of the ARST debate in 1998 was an opportunity lost. Politics triumphed and the result in the form of Infrastructure Auckland is even worse than the previous structure. The rhetoric of Auckland mayors was all about ratepayer control of community assets. The most direct way of reflecting ratepayer control would be through a share giveaway. When this idea was proposed, Auckland local body politicians ran a mile; they even opposed the idea of a referendum on the issue. It turned out that what they were really interested in was political control, not ratepayer control, of commercial assets.

The end result is a case of "California here we come, right back where we started from". The ARST's assets will be put back in the hands of local authorities in Auckland that mismanaged them in the first place. The regional and national economies will forgo the benefits of more efficient commercial operations and the further advantages of potential private ownership. The funds acquired by Infrastructure Auckland will be directed at a non-problem: a minimal set of public goods functions that are currently funded in more transparent and accountable ways. The complex structures of Infrastructure Auckland are unlikely to be an effective shield against special interest lobbying and spending on unjustified activities. In a relatively short period of time we are likely to have the same debate all over again.

In the end, the sorry saga of the ARST's conversion to Infrastructure Auckland demonstrates the failure of those in political leadership to explain the need to understand trade-offs in public policy. The community can have inefficient policies like public ownership or they can have higher incomes and more jobs, but they should not be led to believe they can have both. Those who say they are concerned about poverty and social problems should not complain when they get worse if they consciously support policies which reduce living standards, destroy job opportunities and create unnecessary social stress in their communities.

The handling of microeconomic reforms, including asset sales, are touchstones by which investors judge the quality of the investment environment. The rest of the world is marking New Zealand down fast as a good country in which to do business. The erratic nature of policy decisions, irresponsible comments by politicians on important national issues and cavalier attitudes towards contracts and property rights are all major negatives. The mishandling of various initiatives over recent months is an extension of a lack of commitment in recent years to serious ongoing reform. This has contributed to the deep economic problems that New Zealand is now facing. Those on the margins of our community, and who seek to enter the workforce over the next few years, face a bleak outlook without a revitalisation of the reform effort. This should include revisiting almost every aspect of the recently enacted legislation that created Infrastructure Auckland.

NEW ZEALAND FINANCIAL PLANNING COMPANY

THE PROBLEM WITH PEOPLES' REPUBLICS

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

CHRISTCHURCH
4 AUGUST 1998

THE PROBLEM WITH PEOPLES' REPUBLICS

A few months ago I read a report that more people were on the antidepressant Prozac in Christchurch than anywhere else in New Zealand. I wondered what the explanation could be for this unhappy state of affairs. Obviously it had to be some factor specific to Christchurch. I came to the conclusion that it must be the performance of the Christchurch City Council that's making people so depressed.

Just joking, of course. Christchurch is in many ways a great place; I spent my university years here, and it's one of my favourite New Zealand cities. There's much that is excellent about business, education, culture, sport and the general environment in Christchurch.

Christchurch councils have, over the years, done much for Christchurch. The city fathers, as we used to call them, recognised the importance of fine parks and other civic amenities, were cautious spenders and kept rates low. More recently, the council has done other things to add vibrancy to the city – although it's not alone in this: programmes by councils with different outlooks have had similar results, for example, the promotion of 'Absolutely Positively Wellington'.

But Christchurch has also got plenty to worry about. The whole country is struggling at present because both central and local governments have failed to strive for continuous improvements in New Zealand's economic and social environment, and have dissipated many of the earlier gains with high spending. Canterbury is struggling more than most other regions. Less than two years ago its unemployment rate was 5.6 percent, one of the lowest in the country. In the March quarter of this year [1998] it was 45 percent higher at 8.1 percent, well above the national average. In a longer-term perspective, the government statistician projects that the population of Christchurch will grow by just 13 percent over the next 25 years, whereas Auckland city and other parts of the Auckland region are expected to grow around three times faster.

Regions that are lagging find it difficult to attract and retain bright young people, create new businesses and maintain social infrastructure. They should be doing the most to make their environments business-friendly – to offset competitive disadvantages by striving for excellence in local government policies.

In April of this year Douglas Myers gave a speech on local government on behalf of the New Zealand Business Roundtable. He argued that the benefits of the 1989 reforms had run out, that many councils had lost their way, and that central government needed to initiate a new wave of reform – building on its plans for roading – and refocus councils on their core public goods functions.

The speech was widely reported; the *National Business Review* said it should be mailed to every New Zealander. It agreed with Mr Myers's assessment that the evidence of council underperformance is compelling and added:

> Councils continue to tax well beyond the rate of inflation. They penalise commercial and industrial ratepayers to stay sweet with domestic ratepayers. Councils believe they can run commercial activities better than the private sector when most evidence suggests the contrary. They remain the last bastions of socialism, providing livelihoods for bureaucrats and councillors who would not otherwise be gainfully employed. They shamelessly use legislation (such as the Resource Management Act [1991]) to tax, stop or retard development. They have little sense of direction in a modern economy where the private sector rather than the state is the dynamic force.

Recently the New Zealand Employers Federation reported similar views following a survey of barriers to growth around the country, and I sense there is a groundswell of opinion now building up in favour of change.

Douglas Myers's reference in his speech to the PRC – the People's Republic of Christchurch – obviously struck something in these parts: I'm unsure whether it was a nerve or a chord, or perhaps both. In recent years Christchurch has been perceived as an outlier within local government for its expansive policies. The magazine *North and South* carried an article entitled 'Think Big Buck', and the mayor was clearly happy with the 'People's Republic' accolade.

Reactions to Mr Myers's comments varied. *The Press* said that Christchurch was "not quite China", but added that the view that the council should stick to core services deserved attention, and that it favoured the sale of council shares in Southpower and the Lyttelton Port Company. One councillor wrote to Mr Myers that "some councillors, including myself, agree with you but sadly – at this time – we are in the voting minority". Some letters to newspapers endorsed the concerns about "spendthrift" council policies while others displayed the usual paranoia, lambasting the Business Roundtable for having "greedy designs on assets" and decrying the evils of private enterprise.

My purpose in this talk is to tease out some of the themes in this debate, and a useful starting point is the reactions of Christchurch mayor Vicki Buck. I should preface my remarks by saying that, contrary to the mayor's beliefs, the Business Roundtable does not "hate" Christchurch: most of the major firms that make up our membership operate here, and we want Christchurch to be a thriving part of the national economy. Nor do we disagree on all issues: for example, we are on the same side as the mayor in regarding the government's electricity reforms as an unfortunate move towards re-regulation, contrary to the previous trend of government disengagement from the industry.

One reaction from the mayor was as follows:

> We get told off by BOMA [the Building Owners and Managers Association] and the Business Roundtable. ... But they are the extreme right wing. They believe councils should be involved in nothing. They believe individuals make the best decisions, there should be no rates and no taxes, and we'll all live happily ever after.

Now this is nonsense on stilts. On the right-wing label, I can report that I visited the real People's Republic a couple of months ago and the mayor would be appalled by current thinking and attitudes in that country. China is desperately trying to privatise its state enterprises. Government spending accounts for about 10 percent of the economy (or perhaps twice that figure if you count quasi-government enterprises) compared with around 40 percent in New Zealand. People like Margaret Thatcher, Milton Friedman and Bill Gates are admired and popular figures in China. That this is not the case in New Zealand says far more about this country than it does about irrelevant political labels like 'left' and 'right'. As far as I can see, nothing that the Business Roundtable or BOMA is saying about the Council is very different from the views of the Canterbury Manufacturers Association, the Canterbury Employers Chamber of Commerce and other business organisations. We were one of eight organisations, including Grey Power and the Merivale Precinct Society, that made a joint submission on the Council's Revenue Study.

Moreover, nowhere have we argued that "councils should be involved in nothing", although the mayor of Papakura, David Hawkins, has questioned whether councils will be needed in the long run. We are not anti-government; to the contrary, we want governments to perform their necessary functions, and to perform them better than they typically do when their energies are dissipated on extraneous activities. Government implies taxes and rates. The issue is not whether individuals make the best decisions: individuals in a democracy make *all* decisions, whether that is through the political process, the marketplace or voluntary community organisations. The issue from the point of view of individual citizens is which vehicle is best suited to meeting which needs.

Mayor Buck was somewhat more coherent in an article replying to Douglas Myers in *The Press*. Indeed she got off to an excellent start: she said local government is "about doing those things collectively which we can't achieve on our own". She ought to have also recognised that there are many things we do collectively without the intervention of governments – through families, clubs, voluntary associations, cooperatives and the like – but she is right in saying we need governments to do the things that can't be done as well in the marketplace or through civil society.

She was also in line with government policy toward local government over the last decade. Labour and National governments and the present coalition have been encouraging councils to focus on their core public goods activities: the provision of goods and services that cannot easily be produced and charged for privately. The *public* sector is about ensuring the provision of *public* goods; it should not be about the provision of *private* goods, which should be left to the *private* sector. All organisations (public and private) need to determine their proper role and not be jacks of all trades and masters of none.

In her article Mayor Buck provided a good example of a genuine public good, namely crime prevention. Leaving aside various forms of private security, we all want governments to ensure the security of their citizens: that is their most basic role. She failed to note that crime prevention is essentially a central government role – we hardly want competing police services – but she was right to talk about councils' responsibilities for safe streets and alleyways and public lighting. Councils also often talk about their advocacy role: I hope the Christchurch City Council has made a submission on the current and very inadequate police review, as we have.

There are other local public goods that we need councils to provide, such as open access parks, stormwater and environmental regulation, but the list is not a particularly long one – it does not justify big local government. And there are services with mixed public and private good characteristics, such as sports grounds, where the Local Government Amendment Act 1997 (No 3) requires councils to determine the split and apply user charges to cover the private element of benefits. Hopes were held that this legislation would push councils towards a clearer focus on their public good roles but experience to date has been disappointing. Most have used the escape clauses in the legislation to carry on much the same as before. All too often councils appear to be using *ad hoc* cost allocations and spurious arguments to benefit some interest groups at the expense of others, such as non-voting business ratepayers. When those who benefit from services expect others to pay disproportionally, councils will always be under pressure to provide services of which the benefits to the 'average' ratepayer are less than the costs.

By contrast with its legitimate public good activities, there is a whole raft of Christchurch City Council functions that cannot be justified on the basis of the mayor's criterion that the council should be "doing those things collectively which we can't achieve on our own". Port companies, airports, power companies, passenger transport firms, road maintenance operations, forestry plantations and so forth are providing private goods. All their outputs can be paid for by those who use them; they do not need to be funded from taxation. All such businesses are found in the private sector in New Zealand or around the world, and governments worldwide are exiting from them. The conceit that governments are competent to run businesses leads councils to ride roughshod over the preferences of ratepayers who would rather spend their own money themselves. Christchurch stands out even in New Zealand as a council with an extraordinary range of trading enterprises.

I still hear arguments about privatisation in Christchurch that were discarded in other places years ago. People point to the failures of Equiticorp and Chase, which is about as relevant an argument as pointing to the failures of the Bank of New Zealand (BNZ) and the Development Finance Corporation (DFC). Business without failure is like religion without sin. Losses and bankruptcies, and even the threat of them, concentrate the minds of those whose own money or jobs are at stake on prudent behaviour. Councils are not so motivated and should not be running businesses, which are invariably risky, with other people's money. Christchurch's loss-making tram, which was promoted by the mayor as a profitable venture, is a classic example of political folly. People should be allowed to decide for themselves whether to risk money in commercial ventures. Businesses in political control are not subject to the same disciplines as privately owned businesses, and as a result they underperform on average. It is this inferior *average* pattern of performance in government-owned enterprises around the world that has been the basis for government policies of privatisation.

Christchurch city councillors like David Close have argued that the Council should hold on to assets which generate income because without them rates would have to rise. We have pointed out that this argument is fallacious. Because a business is likely to be operated more efficiently under private ownership, buyers of a council-owned business in a competitive sale process will be prepared to pay more for it than it is worth to a council. As a result the council's financial position improves, and there is scope for rates to go down, not up, just as central government debt and taxes have fallen with privatisation. Councillor Close has accepted that this argument holds insofar as the sale proceeds offset the loss of a council's dividend stream, but he believes it overlooks capital appreciation. I pointed out in a letter to him some weeks ago that he is mistaken as the argument relates to gross returns – dividends plus capital appreciation – and I am still awaiting his reply.

Moreover, from an investment strategy perspective, the Council's ownership of businesses is highly undiversified and therefore risky and inefficient. As financial planners, how many of you would advise your clients to put their money into a handful of utility companies in one geographical location? Given the poor performance of the New Zealand dollar and the New Zealand sharemarket over the last year or two, the Council as an investor has clearly destroyed a large amount of ratepayer wealth by having its investments tied up in local assets rather than in a diversified global portfolio. It cannot even argue that these are relatively safe investments: the Council faces obvious commercial risks in the port industry, for example, as well as the kind of regulatory risks we have recently seen in the electricity industry. Even if it had any justifiable role as an investor – which it doesn't – it is following a very poor investment strategy.

In passing, I might note that those who are worried about 'greedy outsiders' getting their hands on Christchurch assets ought to relax. For a start, I am not aware of any Business Roundtable member company that is interested in any of them. Much more importantly, as a matter of logic there is nothing intrinsically attractive to an investor about government- or council-owned assets anywhere. Investment is a value-for-money issue. Investors can choose from the vast portfolio of investment opportunities available worldwide. Given a competitive sale process, buyers cannot expect to make more than competitive returns on any of them. After the event, those expectations will be realised in some cases, and in others investors will find they have either paid too much or done better than they expected. We have seen all these outcomes in New Zealand. Those who think government or council assets are routinely sold too cheaply should club together at the time of the next sale and put their money where their mouth is.

There might be grounds for concern about the motives of those advocating privatisation if councils were to sell assets uncompetitively. However, for its part the Business Roundtable has long favoured competitive tender processes, open to all bidders. Only where the proceeds are best distributed to ratepayers may it be more efficient to privatise a local government entity by some form of 'popular capitalism' – eg by giving ratepayers title to shares in the company.

It is often said that ratepayers want to retain ownership of their assets: that that is the 'democratic will'. There are a number of points to be made about that proposition.

First, the real test of people's opinions occurs when they actually have the choice of holding a share in an enterprise or taking a known amount of money. Polls fail to provide the necessary information about these options or to give people anything more than a hypothetical choice. There is no need for polls because there is nothing to stop councils giving the shares in the assets directly to ratepayers. Rather than accepting the claims of politicians about preferences for community ownership, ratepayers should be allowed to decide for themselves whether to hold shares in, say, a port company or to put their money into, say, their house, a superannuation fund or a hip replacement operation. If it is really believed that some people get extra satisfaction from community ownership, a community trust could be set up to which they could assign their shares. It was interesting that when these ideas were proposed for the Auckland Regional Services Trust, Auckland local body politicians ran a mile. It turned out that what they were interested in was not ratepayer control but political control. Similar submissions by the Business Roundtable and BOMA in Christchurch have been met with a deafening silence.

Secondly, there is no obvious public policy reason why a majority should be permitted to stop a minority from achieving its preferred option. A share giveaway respects the preferences of all ratepayers. There is no sound basis for making decisions through the ballot box about private commercial transactions. As Mayor Buck says, the political process should be reserved for those things that we have to decide collectively, like law and order. Some people seem to regard the democratic process as suitable for deciding anything; their attitude brings to mind the television episode on Sesame Street where the muppets decide to vote on whether to spend $3 to buy crayons or juice. Rosita says:

> You count the people who want crayons. Then you count the people who want juice. If more people want juice, it's juice for everyone. If more people want crayons, it's crayons.

Telly replies:

> Sounds crazy but it might just work!

Well, we know from the experience of countries that tried to decide things this way that it was crazy and it didn't work. Those who think that decisions on a vast range of issues can reasonably be forced on people by a 51 percent majority vote have a stunted concept of a free and democratic society. If they thought about it for a moment, few of them would agree that a 51 percent majority vote would be an adequate justification for scrapping the Treaty of Waitangi or decreeing that all houses should be painted blue. There is more to democracy and a free and civilised society than majoritarian politics.

Thirdly, voting is no way to approach issues that should be judged in the first place on the basis of logic and evidence. Two plus two will not equal five, no matter how many people may say otherwise in a poll. As one analyst put it recently:

> Consensus and majorities in straw polls are equally invalid as a basis for making sound economic decisions. A present example is the oft-repeated statement that "a majority of the population is against privatisation". Even if this were the case it is no sound basis for retaining public ownership of assets when all the economic evidence indicates otherwise. Many of the major advances made by human society have, from the outset, been made through sound analytical thinking which was contrary to public opinion and consensus.

Voters are too busy and have too many competing priorities to want to invest in the detailed information necessary to make a well-informed decision about each and every council matter. Having elected councillors they expect them to master that information and make sensible decisions on their behalf. Local Government New Zealand has stressed that community consultation is not a substitute for reasoned decision making. Councillors owe electors their judgment on the merits of policy choices. As Edmund Burke put it in his classic statement on the concept of representative government:

> Your representative owes you, not his industry only, but his judgment; and he betrays, instead of serving you, if he sacrifices it to your opinion.

Does this mean councils should go ahead and sell assets regardless of public opinion? Not necessarily, but it does mean that elected politicians in a system of representative government have a duty to inform themselves about policies which offer greater benefits to the community and present information and analysis to voters. There is plenty of evidence that people change their minds when presented with sound facts and arguments. Otherwise we may as well dispense with the expensive apparatus of councils and rely on straw polls instead.

In the final analysis, communities need to understand the trade-offs. They can have inefficient policies like public ownership or they can have higher incomes and more jobs but they can't have both. Those who are concerned about poverty and social problems should not complain when they get worse if they consciously support policies which reduce living standards, destroy job opportunities and create unnecessary social problems in their communities. As Douglas Myers put it, Christchurch is free to decide it is culturally different, but it is not free to repeal the laws of economics.

The key point I have been making is that if we want sound social decisions to be made – decisions that will make our communities more prosperous, safe, cohesive and environmentally agreeable – we must choose the right decision-making mechanisms. Decisions about the different things people want are best made in different ways. Some are best made through the political process, others through transactions in the marketplace and others in the voluntary sector.

The boundary between the public and private sectors needs to be closely patrolled. Each has a different role to play. And within the public sector, there needs to be a clear demarcation between the responsibilities of central government and those of local government.

The problem with Peoples' Republics is that these important distinctions get hopelessly blurred. The public sector expands, the private sector is crowded out, governments become over-extended and core functions are performed badly. One of the reasons for the present problems in Asia is that politicians and business people were not clear about where politics ended and business began. *The Press* is right to say Christchurch is not quite China, but the council has become seriously confused about its proper roles. Its core roles do not include social welfare, education and law and order: those are the business of central government. Nor do they include the provision of marketable goods and services: that is the role of the private sector. They do include things like environmental regulation, which the Council is handling poorly, and where it may fail to survive challenges to its city plan in the Environment Court.

Think Big strategies were disastrous at the national level, and their long-term effects at the local level are no different. Without a change of direction, I fear that the use of Prozac in Christchurch will continue to rise. If Christchurch is to promote a healthy economy, reduce its unemployment rate and compete successfully with the rest of the country, the next council needs to think smaller about its role, its rate levels and the burden of regulation it places on business. If it needs help, the present inhabitants of the Great Hall of the People in Beijing could surely teach it a thing or two.

INDUSTRY POLICY AND REGULATION

FARMING FOR THE FUTURE FORUM

AGRICULTURAL MARKETING AND STRUCTURES: MULDOONISM LIVES ON

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AGRICULTURAL MARKETING AND STRUCTURES: MULDOONISM LIVES ON

When I last spoke to a farming group in the Wairarapa a few years ago, I had a very simple message.

I said that while the economy was in much better shape after a decade of reforms, government policies were going badly off track again. I pointed out that nothing serious was being done to fix the self-inflicted problems of outdated agricultural marketing regulations and structures. For those reasons, I thought the outlook for traditional farming in New Zealand was poor.

The audience wasn't very receptive. The economy was growing strongly, farm incomes had recovered, land prices were moving up, and the producer boards were dismissing their critics as a bunch of theorists who knew nothing about agriculture.

It got worse. Federated Farmers of New Zealand, previously a reliable ally and sharp critic of poor policies, kept praising the government's economic management despite the massive increases in government spending that were underway. It even promoted more spending – arguing, for example, for the removal of the superannuation surcharge. Farmers resisted important reforms in areas like postal services, electricity and roading. Arguments about producer board reform continued to fall on deaf ears.

Finally farmers realised they were being hit by the pressure on monetary policy of excessive government spending and by the government's failure to press on with microeconomic reforms. However, the responses of their representatives at the time bordered on the eccentric. The New Zealand Dairy Board started agitating for intervention to bring down the exchange rate. Federated Farmers started an argument about how migrants' transfers were recorded in the balance of payments and wanted the Reserve Bank of New Zealand to be given the power to manipulate goods and services tax (GST). Not until Malcolm Bailey took over as president of Federated Farmers did sanity return, and media releases appeared with headlines like "1997 Budget Largely Fails Farmers".

What has happened since 1993 is that New Zealand has progressively lost the plot. By reverting to 'do nothing' mode, Jim Bolger's government let New Zealand slip backwards relative to countries that kept working to improve their economies. By presiding over a spending programme of 'Think Big' proportions, Bill Birch killed the goose that was laying the golden eggs. The result was inevitable: a balance of payments blow-out, a credit rating downgrade, a reversal of the fall in unemployment and a recession in the first half of 1998.

Investors finally blew the whistle – only the timing and details of their responses were influenced by factors like Asia and the drought conditions prevailing in areas of New Zealand. They marked down the New Zealand dollar, forcing adjustments including a transfer of resources back to the internationally competing sectors of the economy. Now the government is claiming credit for a recovery from the recession we didn't have to have.

The reality, however, is that the economy is still woefully underperforming relative to its potential, to the achievements of the mid-1990s, and even to Australia which notched up 5 percent growth last year despite the Asian crisis. The National government is not within sight of achieving the 3.5 to 5 percent average annual growth rates that it set as a target going into the last election. When do we hear the government measuring itself against this benchmark and telling us how it is going to achieve it?

Although the outlook for the export sector is now at least temporarily better, my assessment is that agriculture is in dire straits. Last month Owen Jennings bluntly said that farming is going broke. Most of the indicators are pointing in that direction. This is happening despite the fact that the real exchange rate is now below its long-term average and may well appreciate somewhat in the period ahead.

An analysis of the predicament of agriculture usually starts with an observation about the downward trend in commodity prices over the long term. But there is nothing special about this trend. Car and aircraft manufacturers, for example, have seen declining real prices for years. The prices of products in the booming telecommunications and information technology industries have been falling dramatically. Yet these industries are highly profitable and growing because they are increasing their productivity and bringing new products to the market at phenomenal rates. Competition in deregulated markets forces these continuous improvements.

The response of these industries to competition and price trends has been completely different from that of New Zealand agriculture. For years farmers have seen themselves as takers of declining prices on world markets and have wanted to be price makers. Whenever prices fell they blamed the marketers. So they backed the regulation of product marketing, sometimes to the extent of supporting statutory single-selling organisations, in the belief that they could somehow rig world markets and improve their returns.

At least in today's world, this producer board ideology is a naïve and fatal conceit. New Zealand is selling into deep and sophisticated markets for all its agricultural products, no matter how much those markets may still be distorted by government interventions. On the supply side it is facing competition from domestic and other foreign producers. On the demand side, there are substitutes for everything we produce, and consumers will switch to them if New Zealand exporters attempt to rig prices. The monopoly mindset of the producer boards leads to arrogance towards consumers – one of the deadliest of business sins. Our statutory arrangements cause friction with our trading partners. Mike Moore used to defend them on the grounds that monopolies were bad at home but fine when they exploited foreign consumers. Such a view is equally flawed – he will need to change it if he really wants the World Trade Organisation job in Geneva. The trading boards are much more in the nature of monopoly buyers than monopoly sellers and, like the former monopoly trade unions, the people they really exploit are their own stakeholders.

It makes no difference to this analysis whether our farm exports are commodities or processed products. We simply cannot manipulate markets by using producer boards. At the commodity end of the spectrum, whoever heard of an Australian iron or nickel producer suggesting Australia would achieve better prices with a single seller? At the sophisticated end of the market, who advocates a marketing board for the American computer industry? Such structures simply don't fit anywhere in the world economy today.

It may well make sense in some cases for our farm industries to move away from commodities to more highly processed products. Because of price averaging, the need to handle unconstrained volumes, and one-size-fits-all strategies, producer board structures have biased the pattern of exports towards the commodity end of the range. But competitive markets will sort out where the best returns lie; we don't need central planners to do the job. The economic law of comparative advantage tells us that some industries in some countries will do best by specialising in commodities for at least a part of their production. It may make sense for New Zealand to grow wool, scour it, spin part of it and produce some lines of carpet but not to aspire to be a leading producer of, say, men's woollen suits. All parts of the so-called value chain are highly competitive – there are no automatic gains to be derived from farmer investment in off-farm activities. Entrepreneurs risking their own money, not statutory boards or industry 'visionaries' with access to compulsory levies, should make those decisions.

The preoccupation with product prices has had another major downside. It has diverted attention from the only thing that finally matters in business, namely profitability. To this day, producer boards seek to justify their performance in terms of the price received for a kilo of wool, a kilo of milk solids, a tray of kiwifruit or a carton of apples. However, such measures are irrelevant in the absence of information on what is happening to returns on investment. And it is precisely accurate information on returns on investment that is sparse or non-existent for most of our agricultural industries, as the ACIL report for the Business Roundtable emphasised. With the present structures, farmers and other decision makers are navigating in a fog, and without navigating instruments.

There are many other elements to the case against producer boards. Sir Dryden Spring's claim last year that the case had not been made was itself a giant hoax. A brief list goes as follows:

- There are almost always operating inefficiencies associated with monopolies – we have yet to see a monopoly whose performance did not improve when opened up to competition.

- Single-seller arrangements stifle entrepreneurship and innovation by preventing people with other ideas from finding better ways to do business.

- One-size-fits-all strategies expose whole industries to mistakes like the recent foreign exchange disasters or the Customs issue in the United Kingdom;

- In the case of meat and wool, the threat of changes to regulations and board interventions creates uncertainty and hampers long-term planning and investment.

- Foreign investment, and through it the development of new linkages with markets, is blocked or discouraged.

- To varying degrees, price signals to farmers in most industries are distorted by the bundling of payments for raw materials with returns on off-farm investments. Land prices are artificially inflated as a result.

- In order to do business, farmers are often compelled to invest heavily in off-farm processing and marketing operations; they are unable to diversify their risks efficiently.

- There are weak disciplines on the performance of the cooperatives given the absence of share prices and the potential for takeovers, and the accountability of boards for the use of levy payments is also weak.

- With cooperative structures there are constraints on capital raising, and on business strategies which would involve participation in other industries and markets.

- The existence of the boards and their regulations means the industries are bedeviled by politics – both industry and national politics. An enormous amount of the time of industry leaders, managers and farmers is diverted from commercial priorities. As the chair of the Dairy Board, John Storey, put it recently, "what I see is more and more politics and less and less practicality".

This is by no means the full set of constraints and distortions in the main pastoral and horticultural industries. Each is different, but the main problems are common. However, the argument should really be turned completely around. The basic question that should be asked is why we should prevent anyone in these industries doing business with anyone else, at home or abroad, on any terms they choose. Why do we treat the marketing of dairy products, meat and wool, apples and pears and kiwifruit differently from all other industries in the economy, including forestry, fishing, other meat, other horticulture, wine, cut flowers, vegetables and the rest of the primary sector?

As a matter of public policy, there must be very compelling grounds for denying people such commercial freedoms. In general there are none in these industries. Analysis has shown beyond doubt that arguments such as weak selling, scale economies and distorted world markets do not justify different commercial laws. Essentially we should normalise and depoliticise these industries. The only situation that may warrant intervention is where New Zealand is selling into unusual quota markets where competitive marketing would erode the significant premiums that can be obtained if exporting is restricted. The only large markets where this issue arises at present are the European Union markets for butter and sheepmeat. These markets justify at most specific export licensing arrangements, not the present paraphernalia of boards and regulations.

The critics of producer boards do not argue for doing away with them, merely for removing their statutory privileges and putting them on the same basis as all other industries. It should then be for farmers to decide such things as whether to demutualise the cooperative structures and whether to raise levies for research and development under a generic framework like the Commodity Levies Act 1990. Personally I have no doubt that the present structures are costing New Zealand farmers and the economy hundreds of millions of dollars a year in lost income. The economic gains from deregulation and corporatisation would rank with those from the removal of tariffs and the deregulation of industries like transport and communications.

The Business Roundtable took up the issue of producer board reform after the efforts of people like Jim and Bill Sutton in the Labour government failed in the late 1980s. We did so because we see these structures holding back the economy, not because the corporate sector wants to take over agriculture as board propaganda would have it. A moment's reflection shows that claim lacks any logic. Given a competitive environment, the returns from investment in those industries will be much the same, adjusted for risk, as in other industries here and abroad. In general, it is only if individual firms are consistently better than their competitors that they can sustain abnormally high returns.

Removing the statutory privileges of producer boards will allow enterprising people to look for new ways of doing business in agricultural processing and marketing industries. When they are successful, people in related industries, including raw material suppliers will also benefit. There is no logical reason why profitable innovation would somehow harm them – rather it would make their products more competitive on world markets.

Despite this, board politicians will no doubt keep on making spurious claims about the corporate sector turning farmers into peasants. Farmers should remember the similar arguments by trade union leaders that industrial relations reforms would reduce workers to slave labour, and treat them with the derision they deserve.

Almost a decade after we took it up, progress with agricultural marketing deregulation in New Zealand contrasts woefully with changes in the rest of the world. South Africa has deregulated all its producer boards and Israel is on the same track. The free-market agricultural and horticultural industries of Chile and Argentina are going from strength to strength. Our horticultural boards like to claim that deregulation elsewhere has been a mistake but they overlook a vital test of that proposition: there are no signs that these countries agree with them and are about to turn back. Their exports have grown significantly post-deregulation. Even Australia has done much more to reform statutory marketing arrangements than New Zealand, with obvious benefits for industries like dairying. This year the Australian Wheat Board will be listed on the sharemarket and a current inquiry into the wool industry could see its statutory arrangements wound up.

What are the prospects for change in New Zealand? Frankly, they do not look good. The National Party has found it convenient to place the blame for our general policy paralysis on the coalition government. However, it was New Zealand First that pushed National into last year's budget announcement that the statutory powers of producer boards would be removed. Once it became a minority government, National seems to have returned to its Muldoonist roots. Muldoon, you will recall, used to say that import licensing would be removed only if manufacturers wanted that to happen. That position was indefensible – import licensing concerned everyone because it harmed the economy, and so does producer board regulation. It took a Labour government to put national interests first and abolish import licensing, with the support by then of many elements in business.

By contrast, National governments continue to put sectional interests first, telling us they will only abolish the boards' privileges if the boards agree. That's like asking a turkey how if feels about Christmas. They seem unprepared to listen even to broader elements of farmer opinion: last year, for example, Federated Farmers' Meat and Wool Section in a well-argued paper took the position that the statutory backing of the meat and wool boards should be removed. Clearly the fabled wining and dining of National Party members by the boards at farmers' expense is still working its magic. With an election coming up, Jim Sutton and the Labour Party seem to have abandoned their former principles and to be pandering to the diehard supporters of the boards.

So I conclude much as I did when I last spoke on this subject in the Wairarapa. The sound economic framework of the early 1990s has progressively disintegrated. The return to Muldoonist spending habits means that government expenditure will have increased as a proportion of national income for four successive years by the coming financial year, according to the government's projections, making a mockery of its goal of reducing the ratio. Again like Muldoon, the government's regulatory habits are becoming more and more interventionist, often showing little respect for property rights. All this is squeezing the private sector, including agriculture. There is no sound strategy for growth, or for dealing with risks such as the current account deficit and the level of external debt. On present indications the policies of the centre-left parties would be even more damaging to the productive sectors of the economy. A weak policy environment affects the outlook for all industries and businesses. The agriculture sector continues to carry, the additional burden of producer board regulation. In an underperforming economy, I can only see farming continuing to decline. As someone who grew up on a farm, and with a close affinity to agriculture, I find that a pitiful prospect.

The only good news in this story, if there is any, is that the dismantling of producer board regulation is, in my view, only a matter of time. Like import licensing, the overwhelming case against it will be increasingly accepted, and the political constituencies supporting it will fall away. The internal dynamics in most industries are working in that direction. The views of the heavy hitters now leading the dairy industry about where the industry needs to go must be the country's best kept secret. And support for the meat and wool boards keeps falling away – more farmers each year are asking what they get for their average $5,000 levy payment. However, change could still be a long time coming. Malcolm Bailey has compared the process with the abolition of slavery. Unless more farmers themselves push for change, those fighting to defend the boards' privileges in the National Party and any alternative government may well hold out for some years. In that event, a great deal more damage will be done to the farming sector and many more opportunities will be lost before deregulation comes around. I leave you to draw the obvious conclusions.

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE DISCUSSION PAPER ON THE OPERATION OF THE SPECIFIC THRESHOLDS FOR PRICE CONTROL FOR ELECTRICITY LINE BUSINESSES

FEBRUARY 1999

1 Introduction

1.1 This submission on the Ministry of Commerce's December 1998 paper entitled *Electricity Industry Reform: Discussion Paper on the Operation of the Specific Thresholds for Price Control for Electricity Line Businesses* (the Paper) is made by the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand business firms. The purpose of the NZBR is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 The NZBR has taken a close interest in electricity sector reform issues over the past 15 years. We have strongly supported moves to put the industry on a more conventional commercial footing, subject to only light-handed regulation. We see full private-sector ownership of all electricity businesses as being the natural ultimate consequence of this process.

1.3 In our submission in June 1998 on the Electricity Industry Reform Bill we expressed concern about the apparent lack of adequate analysis underlying the measures; the taking of private property rights without compensation or proof of violation of existing laws or regulations; the inadequate consideration given to options such as privatisation and the removal of any outstanding barriers to competition; and the failure to submit the proposed measures to the disciplines of a Regulatory Impact Statement. On the last point, and in relation to the measures proposed in the current Paper, we understand from the Ministry of Commerce that a Regulatory Impact Statement will be provided on the latest proposals if and when the minister for enterprise and commerce takes them to Cabinet. We welcome the imposition of this discipline.

1.4 The latest proposals are two-pronged. They involve:

- permitting the Commerce Commission to undertake price control enquiries and impose price control where it concludes that competition is limited and price control would be in the interests of consumers; and

- government-imposed performance thresholds for lines businesses.

2 Discussion

2.1 We concur with the government's underlying view that any problems of natural monopoly lie with lines and transmission businesses rather than with the generation or retailing of energy.[1] However, problems of natural monopoly are not necessarily so large as to warrant industry-specific measures and they are certainly not uniform across all aspects of these businesses. In our view, many of the problems New Zealand faces have been exacerbated by the government's failure to move more quickly to the privatisation of generation and distribution companies. We are also concerned that the drift in New Zealand into rate-of-return regulation of line businesses based on optimised deprival values is a threat to incentives to control costs and provide the appropriate quality of supply.

2.2 The Paper and the accompanying Information Brief are alert to the dangers of excessive costs and inadequate quality under current arrangements, but they incorrectly attribute them to natural monopoly in paragraph 11 of the Paper and in point 2 of Part B in the accompanying Information Brief. This leads them to ignore the possibility that these problems are due to the regulatory environment rather than to natural monopoly. In general, an unfettered, profit-maximising monopolist would be expected to minimise costs

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1 See, for example Paul Joskow, 'Restructuring, Competition and Regulatory Reform in the US Electricity Sector', *Journal of Economic Perspectives*, Vol 11, No 3, Summer 1997, pp 119–138 for an assessment of professional opinion on this point.

at the chosen level of output (in order to maximise profits). For the same reason it would also be expected to match the quality of products supplied to the range of customer preferences.[2]

2.3 Problems of excessive costs are more likely in the absence of profit-maximising incentives (as under government or trust ownership) or when heavy-handed regulation has created a cost-plus environment. At a later point the Paper acknowledges that the existing form of regulation of distribution companies arguably amounts to *de facto* rate-of-return regulation and so could be leading to excessive costs.[3] However, the Paper does not make the point that ownership matters for incentives, and its confidence that a regime with greater CPI-X characteristics will reduce cost-plus biases on a sustained basis must be questioned.[4]

2.4 The proposed regime would make the Commerce Commission an industry-specific regulator (in addition to its existing responsibilities), and would impose regulatory burdens on firms that violate thresholds that do not depend on any analysis of market power or any calculation of an imbalance between marginal revenue and marginal cost. In our view both these developments are of concern.

2.5 We are sympathetic to the principles that the Paper suggests in paragraph 14 for the design and operation of specific thresholds. However, in our view the proposed regulation, based as it is on yardstick competition, does not satisfy the first of these principles – credibility. The difficulties are illustrated by the arbitrariness of the proposed weighting systems and the absence of any burden of proof of wrong-doing in terms of Commerce Act 1986 principles. The proposed measures will not address the problem that *de facto* rate-of-return regulation of the industry will put up costs on average by creating a cost-plus environment for all firms above the threshold. A recent paper by Professor Lewis Evans of Victoria University of Wellington has canvassed the difficulties associated with regulation using yardstick competition.[5] The problems lead him to conclude that yardstick regulation is likely to be heavy-handed regulation. The incentive problems associated with heavy-handed regulation are exactly what New Zealand's 'light-handed approach' sought to avoid.

2.6 More generally, the basic presumption, referred to in paragraph 2.2 above and reaffirmed in the two sets of proposed weightings for determining thresholds, that high prices or high rates-of-return or poor quality reflect monopoly is inherently suspect and will cause endless dispute. High prices could reflect higher costs, perhaps because of geographic or competitive considerations, or perhaps because of a demand for greater quality. Professor David Giles and Nicholas Wyatt have found that average cost is markedly sensitive to the volume of output.[6] Variations in average quality across regions may reflect variations in demand for quality. High (accounting) rates-of-return may reflect timing issues, valuation issues or inframarginal economic rents. Policies that simply ride roughshod over objections raised on such grounds will be seen to be inequitable and inefficient.

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2 For a discussion of the provision of quality by an unregulated monopolist, see, for example, section 6.2.1 on pages 91–92 of *Reform of the Water Industry*, New Zealand Business Roundtable, August 1995.

3 Refer to paragraph 32 (i) of the Paper.

4 CS First Boston investigated this question for the New Zealand Business Roundtable in the context of the regulation of roads and concluded that: "Over extended periods of time, price-cap regulation does not generate significant advantages over traditional rate-of-return regulation", although it may have transitional benefits. (See page 69 in *Options for the Reform of Roading in New Zealand*, New Zealand Business Roundtable, June 1993.)

5 *Convergence of Light and Heavy Handed Regulation*, paper prepared for the Transpower Electricity Conference, November 1998 by Professor Lewis Evans, executive director, New Zealand Institute for the Study of Competition and Regulation.

6 David Giles and Nicholas Wyatt, "Economies of Scale in the Electricity Distribution System," Ch 23 of *Models, Methods, and Applications of Econometrics*, Peter C B Phillips (ed), Cambridge, Mass, Blackwell, 1992. Professor Evans discusses qualifications to this interpretation (see footnote 5).

2.7 Add to these irreducible difficulties the incentive problems associated with widespread government or trust ownership and the lack of well-defined objectives for Transpower and it is difficult to avoid the conclusion that the proposed policy mix is unstable. An unstable policy is unlikely to be time consistent. This means that it will create incentives that differ from those that policy makers desire, because decisions are based on how policy might evolve rather than on what it is stated to be. Disappointment with the outcomes that result from poorly analysed problems and heavy-handed regulation will generate pressures for further measures – a process of endless and ultimately unsatisfactory regulatory tinkering with which New Zealand is already too familiar.[7]

2.8 An alternative approach to the fundamental problem of limited competition for local lines would be to put greater reliance on private ownership and light-handed regulation. Compared to the *status quo* and the proposed measures, this approach should increase incentives to minimise costs, provide the level of quality that customers are willing to pay for, and improve dynamic efficiency. While there is a good case that prices would tend to be lower than under a cost-plus approach (because costs can be expected to be much lower)[8] the offsetting consideration is that prices *could be* higher in relation to costs (ie profits could be higher). The credibility of this option also depends on its political sustainability in the face of pressures from customers and competitors.

2.9 New Zealand's limited experience to date with the private ownership of local distribution companies does not suggest that there should be major concerns about private ownership of local lines, subject to light-handed regulation. Local distribution companies need customer goodwill, in part to help protect them against Commerce Act 1986 investigations. On the other hand, New Zealand has had decades of experience with government ownership of distribution companies and the case for change is rightly built on dissatisfaction with outcomes under those structures.

2.10 The choice between such options should only be made after a careful analysis and investigation of their relative strengths and weaknesses. The Paper and its accompanying documents do not perform such an investigation. Paragraphs 7(c) and 7(d) of Cabinet Office Circular CO (98) 5 require all Regulatory Impact Statements to set out feasible options for achieving desired objectives and a statement of the benefits and costs of the proposal and of other feasible options. In our view, this requirement must be met and the assessment should be made available for public scrutiny and comment prior to any Cabinet decisions.

2.11 Paragraph 7(b) of CO(98) 5 also requires a statement of the public policy objective that is "not specified so as to align it with (and thus pre-justify) the particular effects of the proposed regulation". Objectives based specifically on reducing prices to end-users, or forcing down costs, do not pass these tests since they do not meet the economic efficiency criterion which is relevant here. Public policy should be based on maximising the sum of producer and consumer surpluses. Dynamic efficiency is particularly important in capital intensive industries and must be explicitly considered. Measures that might primarily transfer wealth from producers or taxpayers to consumers in the short term, at the risk of adverse long-term effects, should be avoided. In our view, the Paper, at paragraph 13, fails to specify the objective in a manner that complies with CO(98) 5.

3 Conclusions

3.1 The NZBR submits that major public policies should only be promoted on the basis of specific high quality research and analysis that is open to public scrutiny. To this point, the

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7 Two decades of tinkering with New Zealand's accident compensation arrangements illustrate the pattern.

8 See page 17 of Capital Economics Limited's July 1998 report for the New Zealand Business Roundtable, *Regulation of Network Industries: The Case of Telecommunications*, for a brief summary of this trade-off by officials at the Commerce Commission.

analysis has excluded consideration of a major alternative – greater reliance on private ownership and light-handed regulation.

3.2 Pending such analysis we conclude that the proposed measures should not be adopted. One of our major concerns about recent policy in this area is that increasingly intrusive regulations are being imposed on private sector suppliers without proof of any wrong-doing in specific cases or any compensation for infringement of existing property rights. The Commerce Act 1986 exists to deal in a principled manner with problems of the abuse of a dominant position. Bald assertions about the existence of monopoly power in all line businesses are being used to increase the regulatory costs on all, while by-passing the disciplines of due process that would otherwise be required under the Commerce Act 1986. It is particularly instructive that what is arguably the most obvious source of concern about high costs and cost-based prices – widespread government and trust ownership – is being ignored.

3.3 The arbitrariness of the proposed thresholds, the uncertainty as to how the measures will work in practice, and the evident disregard for existing property rights are all unfavourable developments in terms of dynamic efficiency and average costs. In the absence of a more convincing case for these measures, we believe public policy in this area is too focused on achieving immediate price reductions and too dismissive of the longer-term costs of government ownership and regulation, and that it should be reconsidered.

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE MINISTRY OF COMMERCE'S TELECOMMUNICATIONS INFORMATION DISCLOSURE DISCUSSION PAPER

DECEMBER 1998

SUBMISSION ON THE MINISTRY OF COMMERCE'S TELECOMMUNICATIONS INFORMATION DISCLOSURE DISCUSSION PAPER

Summary

- This submission on the Ministry of Commerce's Telecommunications Information Disclosure Discussion Paper (the Paper) is made by the New Zealand Business Roundtable (NZBR), an organisation of the chief executives of major New Zealand business firms. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

- The analysis in the Paper fails to distinguish between profits that arise from successful cost cutting, investment and innovation and profits that arise from the abuse of a monopoly position.

- Assertions that the local loop is a natural monopoly are no substitute for an analysis which substantiates such a conclusion. We doubt that any proper analysis would conclude the local loop is a homogeneous entity in terms of entry barriers.

- In our view, New Zealand's essential problem has been to make the transition from a dominant state-owned statutory monopoly to a competitive telecommunications industry while preserving incentives to invest and increase productive efficiency without too great a cost to allocative efficiency. It is not a problem of entrenched natural monopoly – as competition from cellphones and the new telecommunications company Saturn illustrates.

- From this perspective, New Zealand's achievements in telecommunications have been very encouraging, particularly in comparison with electricity where continuing government ownership, increasingly heavy-handed regulation and the expropriation of private investment values are key mistakes. We concur with the Paper's recommendation that optimised deprival values should not be mandated.

- We welcome the limited proposals in the Paper for less mandatory disclosure. However, in our view the general thrust of the Paper towards greater mandatory disclosure is the opposite of what is desirable. After a decade of increasing competition, the case for existing regulation is reducing and New Zealand should be looking at less, not more regulation.

- In particular, concerns about the Kiwi share should lead to a review of the rationale for maintaining its restrictions. The Paper's proposals for increasing disclosure regulation fail to acknowledge, let alone address, the fundamental information problems that arise. We believe they would not achieve their stated objectives and would be likely to generate pressures for more interventions.

- Our concern that increased mandatory disclosure of commercial information could lead to higher future prices due to a reduced willingness to invest in New Zealand (a loss of dynamic efficiency) are heightened by the possibility of perverse effects on evolving price competition between existing competitors.

- Given its lack of analysis of the source of industry profits and market structure issues, the Paper appears to reflect the view that markets cannot be relied upon to overcome entry barrier problems more effectively than regulators. This is the opposite of the conventional view that private goods are best provided privately without industry-specific regulation.

- Finally, we recommend that the Ministry adopt a policy of always including in discussion papers proposing regulations a section commenting on their conformity with the Code of Good Regulatory Conduct.

1.0 Introduction

1.1 This submission on the Ministry of Commerce's Telecommunications Information Disclosure Discussion Paper (the Paper) 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.

1.2 The discussion paper proposes increased disclosure of: prescribed services;[1] in particular the 0800 service; documentation of interconnection agreements; and financial information from Telecom, particularly in relation to the local loop. The paper also identifies a need for an economic assessment of the net cost to Telecom of its Kiwi share obligations.

1.3 The NZBR has a longstanding interest in these public policy issues. Our most recent contribution to them was the NZBR July 1998 paper *Regulation of Network Industries: The Case of Telecommunications.* This paper questioned the common assertion that local loops are a natural monopoly, raised the question of whether Telecom was making profits or losses on the local loop, noted that the Kiwi share could be inhibiting entry and suggested that further work be done on that issue if entry is seen to be a policy problem.

1.4 The NZBR has also had an interest in the analysis of issues associated with the mandatory disclosure of information. We opposed the mandatory disclosure of executive salaries under legislation that is now the responsibility of the Ministry of Commerce, noting in our submission the reasons why protection of certain information is vital for business efficiency. We suggested that, contrary to the interests of shareholders and the objectives of those advocating disclosure, the effect could be to increase executive salaries, which we believe has been the case. More recently, we commissioned Professor George Benston of Emory University, Atlanta to evaluate proposals for mandatory disclosure of information relating to investment products and financial advisers. His report, *Voluntary vs Mandated Disclosure: An Evaluation of the Basis for the Recommendations of the Working Group on Improved Product and Adviser Disclosure* (May 1997), included an insightful discussion of the potential costs of mandatory disclosure even to the group it is intended to assist. Concerns about the effects of this regime, which was promoted by the Ministry of Commerce, have subsequently been voiced by a number of other parties.

1.5 The NZBR has supported New Zealand's approach of adopting (at most) light-handed regulation of private monopolies. The Kiwi share requirements and the disclosure requirements in section 5 of the Telecommunications Act 1987 are part of this framework. The competitive situation in the industry has changed enormously in the eight years since the current information disclosure regime was introduced and we agree that a review of its appropriateness is timely.

1.6 This submission explores the rationale for the proposed measures and their likely effects. Section 2 discusses the competitive state of the domestic telecommunications industry as it approaches the end of the first decade following the privatisation of Telecom. Section 3 focuses on the Paper's key proposals and the objectives they are intended to serve. Section 4 discusses those objectives from an information cost perspective. Section 5 discusses certain regulatory issues relating to the Kiwi share. Section 6 presents some concluding remarks.

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1 Services that primarily rely on Telecom's local loop for delivery.

2.0 Overview of New Zealand's experience with its current regulatory environment

2.1 In our view, New Zealand's experience with light-handed regulation of telecommunications is encouraging.[2] There have been impressive gains in productive efficiency[3] and in the quality and range of services. Despite the need for tariff rebalancing, unit prices for bundles of services have also fallen rapidly. The old concerns with the statutory monopoly provider about quality of service, network robustness, inability to determine a competitive strategy and the capital expenditure constraints of a government owner are distant memories. Consumers have responded by greatly increasing their use of telecommunications services. Massive and ongoing investment has taken place in the industry, much of it by new entrants.

2.2 A critical factor in this dynamic, high technology industry is that New Zealand has been able to avoid the heavy-handed regulation that poses such a threat to dynamic efficiency – government ownership, rate-of-return regulation and its close relative, CPI-X regulation.

2.3 As in many other countries there have been a series of attempts in New Zealand to secure changes to the regulatory environment during the transition from a statutory monopoly structure. The pressure has fallen on ministers and those responsible for administering the Commerce Act 1986. Ministers have reacted by signalling a willingness to intervene on many occasions. The ongoing threat of future government involvement has surely influenced firms' competitive strategies, and not necessarily for the better.[4]

2.4 Compared with regimes that have sought to legislate or regulate for profitable entry, it has arguably been more difficult for new business entrants in New Zealand to become profitable. But making entry easy for competitors is not necessarily consistent with consumer welfare maximisation. Consumers are not helped in the long run if regulation leads to the replacement of a single dominant provider by an artificially structured industry or a regulated cartel. Nor is it necessarily in consumers' longer-term interests to have regulators hastening the decline in unit prices with measures that take an incumbent's property rights without compensation and thereby reduce the future willingness to invest of the incumbent and other firms.

2.5 The fact that New Zealand has faced ongoing difficulties in extricating itself from the legacy of a statutory monopoly situation should be no surprise. It was always going to be difficult for Telecom and its competitors to negotiate agreements about such matters as interconnection and numbering plans. As with the opening up of the airline and television markets to competition, New Zealand's arrangements rightly encourage the incumbent to be a vigorous competitor, while restraining abuse of a dominant position. The problem is that regulators, entrants and incumbents may be unsure as to whether any specific conduct oversteps this mark. This inevitably means a level of uncertainty about property rights. If it were not for the

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2 In making this comment we put some weight on the remarks of Professor Henry Ergas cited on page 23 of the July 1998 NZBR report. In our view, the Kiwi share constraints complicate the already complex task of making sound international comparisons. More research would be needed to establish any grounds for concern about New Zealand's regime from this perspective.

3 Telecom reduced its cost structure by 38 percent in real terms between 1987 and 1993 according to David Boles de Boer and Lewis Evans, 'The Economic Efficiency of Telecommunications in a Deregulated Market: The Case of New Zealand', *Economic Record*, 1996, 72, pp 24–35.

4 See pages 35 and 36 of the July 1998 report for criticisms of the government's intervention in respect of the Baumol-Willig rule following the Privy Council decision.

government's revealed willingness to override court decisions, this uncertainty might be expected to fall through time as court decisions clarify the law.

2.6 Arguably many of the difficulties New Zealand has faced in making the transition from a statutory monopoly to a competitive market reflect information problems and incentives to 'game' the regulatory system. The fundamental regulatory problem is that it is impossible to objectively determine future costs. Future costs are particularly problematic when technologies are changing rapidly. Without knowledge of opportunity costs, economists cannot determine the level of marginal cost. This means that they cannot readily determine if there is a gap between marginal cost and price. Nor can they tell if there is a gap between marginal cost and average cost. Normal profits result when average revenue equals average cost. There is only one volume of sales at which marginal cost equals average cost. When volumes are changing fast there is no reason to expect that the actual volume of sales will allow marginal cost to equal average cost. Pricing at marginal cost could result in supernormal profits or losses, depending on the volume of sales. Any such profits would be called economic rents by economists and would not be a cause of concern.

2.7 These information problems are largely intractable, except through market processes (see the next paragraph). They challenge politicians, experts, regulators, new entrants, a dominant incumbent and the courts under any set of regulatory arrangements.

2.8 Market processes provide the most satisfactory solution to the problem of deciding whose views should prevail when views about the future differ. Views about the evolution of future costs are fundamentally entrepreneurial. Market processes allow consumers to answer spontaneously and in an uncoordinated manner the question as to whose views will prevail.

2.9 Regulators are much less informed than markets about consumer preferences and lack the incentives to make the best choices. Regulations can force an incumbent to provide information about current and past accounting costs, but they cannot produce objective information about future costs or the value of forgone alternatives.

2.10 The need for regulation should reduce through time if the problem is essentially one of transition from a statutory monopoly. Undoubtedly, many of New Zealand's regulatory difficulties arise from the dominance achieved by a government-owned statutory monopoly. However, if there is also a problem of natural monopoly, competitive entry cannot be expected to occur, at least until technological change removes the entry barrier implicit in the incumbent's much lower marginal cost of production.

2.11 The Paper's proposals are based on the premise that some of Telecom's activities are a natural monopoly. References in the paper to Telecom as a natural monopoly are made in paragraphs 62, 67, 72 and 83. (Paragraph 72 concedes that technological changes are eroding natural monopolies over time.)

2.12 Is the Ministry indulging in rhetoric or does it have some body of analysis to justify these assertions of a fundamentally intractable problem? On what basis do officials disagree with the views of Nobel laureate Gary Becker and other economists who do not see telecommunications as a natural monopoly? Most obviously, the ubiquitous cell phone readily bypasses much of the local loop. Furthermore, converging technologies, falling call charges and the growth of the Internet are generating enormous call volume growth and large investment requirements. How can officials explain the entry of the new telecommunications company Saturn in greater Wellington if they see the local loop as a natural monopoly? In our view it is important that officials answer these questions in order to establish that the analysis underlying their proposals is soundly based.

2.13 The regulation of local loop pricing would be difficult if the local loop really was a natural monopoly. By definition, with a natural monopoly pricing at marginal cost would mean pricing below average cost. While economists preach the virtues of marginal cost pricing once capacity is installed, such pricing would be a threat to future investment. It may also make the incumbent vulnerable to a predatory pricing charge under the Commerce Act 1986 (the Commerce Commission's recent investigation of Telecom's response to Saturn's prices in the Hutt Valley illustrates the potential for such actions). In any case, marginal cost pricing is not commercially viable for the incumbent in these situations. Only if a for-profit incumbent expects future revenues to at least cover the average cost of a future investment can the investment be expected to be forthcoming. Regulations or court decisions that prevent profits from exceeding average cost for any sub-period could deter investment by denying the opportunity to recover losses in bad years from offsetting excess profits in good years. It is therefore important that this issue is resolved.

2.14 In contrast, if the local loop is not a natural monopoly the prime issue is to allow competitive entry to erode the dominance arising from the former statutory monopoly if alternative providers are more efficient, without distorting the competitive process for no good reason.

2.15 It is also plausible that the local loop is far from homogeneous with cost structures varying geographically and by segment of service. Disclosure requirements that relate to the loop as a whole, or to mis-specified portions of it, may be of little value in relation to the Ministry's objective.

3.0 The Paper's proposals

3.1 The Paper proposes (in paragraph 28) that there be less regulation of information concerning international calls and leased services prices and discounts because extensive competition now exists for these services. We fully endorse this approach but question the Paper's qualification that this approach should only be supported if information is provided that "clearly demonstrates that these markets are now fully contestable". The term "fully contestable" is undefined, but it has connotations of an unrealistic zero-transaction-cost world. Consumers currently have ample choice and competition is vigorous with prices falling sharply.

3.2 The remaining sections of the Paper propose extensions to the range of information that must be provided by Telecom. The Paper states that the additional information is required in order to:

(i) assist Telecom's competitors by forcing it to publish commercial pricing information, particularly in respect of 0800 number discounts (see Section 3.4, particularly paragraph 26) and interconnection agreements (see Section 4.4);

(ii) facilitate international comparisons (see Section 3.5);

(iii) help Telecom's competitors determine whether Telecom's access charges determined in relation to its Kiwi share obligations are reasonable (see Section 4.3, particularly paragraph 48); or

(iv) help assess whether Telecom is charging too much for its so-called natural monopoly services, and is subsidising contestable activities (see Section 5, particularly paragraph 62).

3.3 Paragraph 89 is quite explicit about the objective of facilitating competition by "bringing more pressure to bear on Telecom's prices and profits".

4.0 Discussion of the objectives of further mandatory disclosure

4.1 Information is costly to produce. Mandatory disclosure of private information reduces voluntary incentives to produce the same information. Where the information is provided for the public good, mandatory disclosure is a taking of private property. It is thereby analogous to the taking of private land for public works. Payment of compensation for such a taking would be needed to restore incentives to produce such information in future on a voluntary basis.

4.2 These costs are increased where commercially sensitive information is involved. The forced publication of that information is a free gift to competitors. As such it could induce competitive entry. One possibility is that a greater level of entry results in lower prices to consumers in the short-term than would otherwise occur. A second possibility is that disclosure will make it easier for cartels to form by reducing the costs of verifying that the incumbent is sticking to any implicit industry understanding. A third possibility is that mandatory disclosure will reduce the ability of an incumbent to recover common costs by efficient Ramsay pricing. A fourth possibility is that forced disclosure of special discounts will lead to higher prices for the relevant services than would otherwise occur, with no guarantee of comparable offsetting benefits to other customers. In all these cases, the longer-term effects on dynamic efficiency and therefore on consumer prices are likely to be unfavourable. This reflects the near-inexorable likelihood of a trade-off between dynamic efficiency and regulation designed to improve allocative efficiency.

4.3 There is also a risk that the costs of mandatory disclosure requirements will increase over time. This is because the stated objectives are open-ended. As long as the incumbent retains some private information, competitors and those seeking to make international comparisons would always be assisted (other things being equal) if more of it has to be published.

4.4 As argued in Section 2, the fundamental problem in respect of the monopoly issue is that it is future costs, not past costs, that are relevant. Future costs are subjective. There can be no end to the debate as to whether the information disclosed is accurate or adequate. As long as competitors do not have to pay for information, they will always have an incentive to clamour for more as long as the marginal benefit is positive. In our view the greater level of disclosure that the Paper proposes would fail the same tests that it applies in coming to the conclusion that current requirements are inadequate.

4.5 Regulating to put more pressure on Telecom's profits and prices is not necessarily consistent with dynamic, allocative or productive efficiency. What is required instead is an analysis of price in relation to marginal cost, not price in relation to average cost. Regulating to reduce the profits of a firm that has been very successful in reducing average costs is likely to make all potential investors wary of New Zealand. Public policy needs to be particularly careful, therefore, to be seen to be identifying and addressing a monopoly problem. To fail to distinguish between successful cost cutting and innovative development of new products on the one hand and the abuse of a monopoly position on the other would do no service to New Zealand consumers.

5.0 The Kiwi share

5.1 In our view, New Zealand's experience to date reflects the problems of moving from a totally dominant, publicly owned statutory monopoly to a private, competitive, multi-firm industry, rather than the enduring problems of a natural monopoly. The vast majority of new entrants have focused on competing for tolls and business services. Presumably this is where the economic rents were the highest and entry was the easiest. Certainly, prices have been reduced most in this area. However, this does not mean that there would not have been more competition in the local loop in the absence of the Kiwi share.

5.2 To the degree that the Kiwi share has prevented Telecom from raising local loop charges, it has arguably restricted returns and thereby raised barriers to entry to the local loop. The NZBR has repeatedly called for a review of the case for continuing with the Kiwi share restrictions.

5.3 There are two possible reasons why the government might be concerned to preserve the Kiwi share. One is that it believes that the Kiwi share is forcing less politically important groups to cross-subsidise important users – and it wants to preserve these cross-subsidies as long as possible. The comments in the Paper about losses (eg in paragraphs 46, 48, 51 and 52) suggest that officials find this hypothesis plausible. The alternative reason is that it believes that the local loop is a monopoly and is concerned to stop monopoly charges for local lines.

5.4 The first motivation would be inconsistent with the objective of economic efficiency. A much sounder approach would be for parliament to explicitly debate such subsidies, and to fund them transparently should it desire to do so. If Telecom is making losses because of forced subsidies it should be possible to negotiate terms under which it would purchase its way out of the existing requirements.

5.5 Although local lines do not appear to be a natural monopoly, some monopoly pricing may be possible during the transition from a statutory monopoly. Telecom's competitive response to Saturn's entry in Lower Hutt demonstrates the scope for competition in the local loop to drive down prices. Saturn's entry into Auckland could have a similar effect on prices in that region. Two things could affect Saturn's decisions (or those of any other potential competitor). The first is its perception of Telecom's willingness and ability to cut prices in Auckland as significantly as it did in Lower Hutt. In the absence of government regulation, any competitor would surely presume that the law of one price must prevail for a commodity product, as the recent petrol price reductions illustrate. On this view, Telecom must be expected to cut prices to the extent necessary to remain competitive in Auckland. Saturn has indicated that it will delay a decision on entry in the hope that the government will intervene on its behalf. As long as it perceives the probability of such intervention as being material, such a strategy would be consistent with shareholder value maximisation regardless of what decision it actually takes in future. This game-theoretic situation simply demonstrates that the threat of regulation has the potential to delay otherwise profitable entry. But the government should hesitate to stop Telecom from reducing prices selectively to Aucklanders in the hope that this will facilitate Saturn's entry for the obvious reason that governments have no sound basis for depriving Auckland consumers of lower prices for the benefit of a new entrant.

5.6 Secondly, Saturn's entry decision in Auckland could also be delayed by its perceptions that the government desires to regulate so as to lower access charges for those seeking interconnection. The Paper's focus on assisting competitive entry by those not competing with the local loop leads it to ignore the implications of any interventions for those seeking to compete with local loop services (see, for example, paragraphs 26 and 48). If lower charges for the local loop prevent further competitive entry, the same competitors will use the absence of entry to argue that entry barriers, and therefore Telecom's charges, are still too high. Such a treadmill would be a threat to all investment in the local loop.

5.7 To conclude, in our view it is critical for dynamic efficiency that public policy does not undermine incentives to invest in the local loop. Talk of losses arising from the Kiwi share and the focus of the Paper on reducing returns to the local loop at a time when demand for its services is growing very fast only serve to heighten these concerns. The Paper needs to acknowledge the reality of new competitors such as

Saturn and to consider explicitly the effect of its proposals on incentives to invest in the local loop.

6.0 Concluding comments

6.1 In our view, less, not more, regulation in network industries where competition is increasing is desirable with the passing of time. The key mistakes in electricity have been the continuation of government ownership, the drift into rate-of-return regulation through the use of optimised deprival values, and the desire to transfer value from taxpayers and shareholders to consumers for short-term political reasons. We are particularly concerned about the implications for New Zealand's reputation in the eyes of investors of any continuing indications of governmental willingness to expropriate property rights of incumbents without compensation.

6.2 Any concerns about 'natural' monopoly are much less warranted today than they were in 1989. Assertions about natural monopoly do not suffice to justify the proposed interventions. In our view, the proposed regulations will fail to achieve the objectives officials have in mind. The objective in relation to the cost of the Kiwi share appears to be particularly ambitious given the international difficulties discussed above. Disappointing outcomes will generate demands for further regulation. There is no satisfying such open-ended demands. A cost-benefit approach must be taken to all regulatory proposals.

6.3 The continuing existence of the Kiwi share constraints is hampering the development of competition and prolonging uncertainties about the government's attitude to hidden cross-subsidies. Rather than increase the amount of regulation associated with these constraints, the government should review their continuing rationale. The elimination of unjustified restrictions could well help overcome some of the problems perceived by Telecom's competitors.

6.4 Finally, there is no indication in the Paper that its proposals conform with the Code of Good Regulatory Conduct. As a matter of principle, the Ministry of Commerce should set an example in this area by making it a matter of policy that all its regulatory proposals contain a statement of their consistency with that Code.

NEW ZEALAND RACING MANAGERS CONFERENCE

WHY NOT NORMALISE RACING?

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

CHRISTCHURCH
4 AUGUST 1998

WHY NOT NORMALISE RACING?

1 Introduction

I have been asked to discuss the future of racing. I would like to focus on two main issues: 1. establishing the best regulatory environment for racing, and 2. the implications of deregulation for the racing industry. I shall also mention taxation and privatisation.

These issues are familiar territory for the New Zealand Business Roundtable, but, we have not however, done in-depth work on the racing industry, although we have done so on gaming. I am, therefore, speaking in a personal capacity.

When I received the invitation to take part in the New Zealand racing managers conference I recalled my earlier exposure to the racing industry as a Treasury official. Sir Robert Muldoon was a racing enthusiast, and his status as prime minister and minister of finance led many in the racing industry to beat a path to his door. The habits continued with Trevor de Cleene and John Falloon. Someone was always pressing them to preserve a race meeting on the West Coast or some other remote location, or to tweak the racing duty system to give a higher return to the punters or racing clubs. It was my view then that governments do not have the right information or incentives to make sensible decisions about any industry. Nothing that has happened since leads me to change it, or to believe it doesn't apply to racing.

Indeed this conviction has been reinforced by New Zealand's experience of reform over the past 15 years. The reduction in government involvement in businesses through deregulation and privatisation and the moves to lower and more even rates of taxation have consistently resulted in a better deal for consumers. As government intervention has reduced, the range of goods and services available to New Zealanders has increased, the quality has improved, and prices have come down. Deregulation has required major adjustments by industry participants. Those that responded – the vast majority – have thrived in the new environment. Those that tried to continue with the old ways of doing business have disappeared.

Few would suggest that we should return to the days of high costs and limited choice in industries as diverse as air travel, telecommunications and motor vehicles. But it is salutary to remember that in each case the changes were highly controversial when they were made.

The need for adjustment in the racing industry is being driven by social and economic changes in New Zealand, including liberalisation in other parts of the economy. Consumers have greater choices over how to spend their time and leisure dollars. Shops are now open all weekend, and a variety of alternative entertainment and gaming opportunities are available. People expect products of higher standards, tailored to their particular preferences.

The racing industry has not responded adequately to these changes. Although some changes have occurred, they are insufficient. Industry profitability, racing's share of the expanding gaming market, the horse population and, I am told, morale among stakeholders are all in decline. My view is that the continued government involvement in the industry, as well as the legislative protection of existing participants and structures, are major factors preventing much-needed adjustment.

Racing has enjoyed a special status, with its own legislation and minister.

Why do we have a minister for racing? We seem to get by without having ministers for our other icons, rugby and beer. It cannot be because horse breeding is critical for national defence – the military stopped using horses after World War I. It cannot be because racing involves gambling. If that were the reason we would have ministers for lotto, gaming machines and casinos. It cannot be because racing is an infant industry – it has been around in New Zealand for over 100 years.

The answer is that just a decade ago people involved in racing persuaded politicians that a minister for racing was needed. However, despite this political patronage, the total amount of money spent each year on betting on races is now less than that spent at casinos or on gaming machines, neither of which were legal in New Zealand 10 years ago. Racing has lagged behind other industries that have been restructured over the past 15 years.

Racing's special status has probably held the industry back. Political patronage brings with it risks and costs. Most politicians, once elected, want to be re-elected. They often think the best way to achieve re-election is to try to please everyone. The problem is that the current voters the politician tries to please will not include the future customers the racing industry has yet to win. Politicians will favour existing industry players and ignore potential new entrants. The result is that politicians tend to preserve the past rather than prepare an industry for the future.

Many of New Zealand's best export success stories, such as computer software and boat building, have prospered without political patronage. In contrast, sectors that have attracted political patronage have often been the poorest performers in recent decades. Sheep farming and fishing have experienced the boom and bust cycles caused by politically encouraged over-investment followed by painful restructuring. Industry politics bedevils our farming industries. There might be a lesson for the Racing Industry Board in the sorry saga of producer boards that appears to be coming to an end.

However, political involvement in the industry is not the only constraint. The legislative restrictions that constrain opportunities in the industry are probably even more important.

2 Regulation of the Racing Industry

The Racing Act 1971 requires that:

- race meetings can only be held under the supervision of a racing club;
- licences have to be granted to run a race meeting on a particular day;
- the number of races that can be run under a licence is limited to 10 in one day;
- the Totalisator Agency Board (TAB) has a monopoly on off-track betting services;
- it is illegal to extend credit for a person to bet; and
- bookmakers are banned from racecourses.

In addition, a licensing regime exists for participants under the rules authorised by the Act.

These restrictions are over and above those that apply to gaming generally. It seems fair to ask whether racing would be in a better position if it didn't have this level of regulation.

Why can't private companies run race meetings? In many sports, corporates or private individuals own venues and run sports events. The rule that race meetings must be supervised by racing clubs forces the use of a particular kind of organisation and one that may not always be the most efficient provider of racing services.

A level playing field would not only allow private companies to provide racing services but would also bring the tax treatment of all suppliers of racing services into line. Neutrality would require removal of the tax-exempt status of clubs.

In the past the total number of licences available has been an issue. In recent years it has been less problematical, but access to licences for the most attractive days remains hotly contested.

The increasing importance of the off-track bettor, now providing more than 90 percent of betting turnover, has made access to the Trackside channel on television a critical issue for the profitability of a race meeting. In the current format only six races per hour can be shown on the Trackside channel. Tendering could be used to allocate the slots to those who value them most highly.

Why must there be no more than 10 races per racing meeting in a day? We do not tell McDonald's that they can only serve 1,000 Big Macs a day from each outlet. It seems to me that the number of races held on a day should be determined by the interplay of commercial factors rather than by legislative fiat.

The racing industry provides outputs – race results – which are inputs to the betting industry. In the absence of some legislative protection of the 'property rights' to race outcomes, bookmakers could make a book on races without contributing to the cost of racing. If there were no protection of the use of race outcomes the racing industry might provide fewer races and all parties would be worse off. Legislation constraining the use of race outcomes by requiring negotiation of a payment with the race promoter might therefore be justified. This is a standard property rights issue.

Other issues associated with gambling do not appear to justify provisions in the Racing Act 1971. I cannot see the justification for establishing the TAB as the monopoly provider of off-track betting services. Racing clubs cannot know they are getting the best possible deal from the TAB if no one else is able to compete with it. It may be that the current TAB is doing a very good job, but without competition how do we know? It's hard to see why bookmakers should not be allowed to operate on racecourses provided they paid a proportion of their turnover on an agreed basis to individual clubs, as does the TAB.

Much of the gaming regulation appears to be designed to restrict competition in the provision of particular gaming products. In its submission to the Gaming Industry Review the Business Roundtable concluded, after examining the international evidence, that gaming was not so different as to justify the extensive regulation that has characterised the industry. The thrust of our submission was that the regulatory framework for gaming should be brought into conformity with that governing the supply of other goods and services, except where there are valid public policy grounds for industry-specific interventions. In particular, we argued that the government should:

- abolish the licensing of gaming operators and allow any class of business, including for-profit firms, to provide gaming;
- abolish mandatory contributions to community assets and industry-specific taxes;
- fund community activities out of general revenue, where these merit subsidy; and
- remove government agencies from the provision of gaming services.

The changes to gaming legislation that we proposed would affect the racing industry in several ways:

- Taxes paid by the industry would be reduced (although any change might be partially offset by increased taxes on profits if the clubs' tax-exempt status were removed). The way in which racing duty rates are set is somewhat obscure to me, but at least three cents in every dollar bet goes to the government. Goods and services tax (GST) is already levied on racing, and there is no justification for an additional impost. The reduction in tax could allow an increase in stakes paid to owners or returns to punters.

- The racing industry could run gaming machines, lotto and casinos but would face new competitors in racing and new entrants providing the current or new gaming products.

Even without deregulation of gaming, the racing industry is likely to face increased competition, particularly from gaming opportunities offered over the Internet. Competition from this source, which cannot be regulated, can only increase over time.

What are the prospects of the government moving to deregulate the industry? Speeches by the minister for racing over the last year indicate that it may be prepared to facilitate some deregulation of the industry, but that it is constrained by its legislative programme. It is regrettable when governments cannot make a decent fist of doing the things we need them to do – like passing laws – when at the same time they engage in all sorts of things – like running coal mines and television channels – that shouldn't be their business.

Deregulation would inevitably change racing, bringing it closer to providing what customers – including off-track bettors, race course visitors and owners – want, and thereby giving the industry a more secure future. A future built around special treatment and licensing will not allow the industry to adjust fast enough in the dynamic market for the recreational dollar.

3 Implications of deregulation for the industry

Deregulation of an industry can be expected to force incumbents to reduce costs, rationalise their operations, and better meet the needs of customers. Possibilities for the industry in a deregulated environment for racing could include:

- private operators running race meetings and providing venues;
- higher betting turnover funding higher stakes for owners and improved payouts to bettors;
- a smaller number of venues and clubs as rationalisation occurs to reduce costs;
- a rationalisation of the industry structure which appears to have multiple administrative layers (eg the Racing Industry Board and underneath that the New Zealand Racing Conference and Harness Racing New Zealand) or displacement of these structures by a competing organisation;
- the TAB negotiating with racing providers to distribute profits on terms that reflect the actual profitability of the race meeting and the betting revenues it generates;
- a wider range of betting products and more innovation in how racing is organised, eg a two-league system with different handicapping rules in each;
- globalisation of the gaming industry with competition from new providers through the Internet; and
- greater use of professional managers in the day-to-day control of racing.

Beyond these possibilities there might be all sorts of opportunities for bundling up sporting and gaming activities using different technologies to reach new audiences.

Is the industry as it is currently structured well placed to meet the challenge of deregulation? Two things strike me when I look at the industry structure, although my understanding of it may be incomplete. The first is the predominance of non-profit and unconventionally structured organisations (both for racing and the TAB) to administer business activities. The second is the extensive use of rules and bureaucratic procedures for allocating resources rather than reliance on normal market mechanisms.

The legislative requirement that race meetings can only be provided by clubs compels the use of a particular kind of organisation that may not be the most efficient provider of racing services. A fundamental issue for consideration is whether the non-profit club structure is likely to be the most efficient way of delivering racing services into the future.

The major difference between for-profit and non-profit forms is that in the former owners have the right to the residual income of the organisation, whereas in the latter those controlling the assets cannot pay themselves a dividend. These differences affect the incentives of the different organisations to produce the outputs consumers and others prefer at minimum cost.

Managers of private for-profit organisations face strong incentives to produce the services their customers are willing to pay for at minimum cost, since that maximises the profits of a firm. Disciplines are imposed on managers of for-profit firms by the threat or reality of a takeover and competition in the labour market for managers. Because private shareholders have a direct financial interest in the organisation they own, they have strong incentives to monitor management and to take action when they perceive weaknesses in performance.

In a non-profit organisation there are no shares or ownership rights that are traded. Profits cannot be distributed to those who exercise control over it, so that financial incentives to gain control of a non-profit firm and improve its performance are absent. Takeover of the organisation is usually very difficult. The result is that non-profit organisations generally have weaker incentives to operate efficiently.

For-profit firms often have ready access to private capital markets for capital financing. Non-profit organisations cannot readily obtain equity funding from capital markets or private investors. Instead, they typically rely on donations, government funding, retained earnings and debt for capital financing. These sources of funds may be inflexible and may not adequately match the organisation's capital requirements. Thus, where capital requirements are large and donor funding sources are not important, a for-profit organisation will offer advantages in capital raising.

There may be advantages in a non-profit form of organisation where funding from donors or input from volunteer workers is important. The non-profit form can provide donors with reassurance that owners will not capture their contribution through higher distributions.

Non-profit organisations are also sometimes considered to have an advantage when it is difficult for customers to measure the quality of outputs produced. A non-profit organisation may have fewer incentives to skimp on quality and may thus provide a signal of trustworthiness. This is the explanation sometimes given for the predominance of non-profit organisations in the health care sector.

In the case of the racing industry, the services produced do not appear particularly complex, so the ability to skimp on quality does not seem a good explanation for the non-profit form. There might be concerns over the manipulation of race outcomes, although this is not necessarily overcome by a non-profit industry structure. Donor and volunteer labour inputs may be a relevant factor in favour of a non-profit structure in the case of some clubs. Against this is the need for the industry to access capital to upgrade facilities, and the weakness of incentives for performance that go with a non-profit arrangement.

I will leave it to you to assess where the balance of the arguments might lie. Naturally I am not arguing that club ownership should not be an option for those who want to retain it. However, it appears to me that the non-profit structure of the industry may be impeding change.

It is also interesting to note the shift away from the non-profit form in some other industries. There has been a wave of demutualisations in the insurance industry. Here, non-profit organisations effectively owned by policy-holders have been converted into conventional corporate forms. Another example is hospital care in the United States which is predominantly provided by non-profit organisations. However, there has been an increasing trend towards conversion of non-profits to for-profits – the number of hospitals converting from a non-profit to a for-profit form climbed from 15 in 1992 to 347 in 1995.[1]

I suggested earlier that the TAB should not have statutory protection from competition. I also believe that the current structure of the TAB is unsatisfactory. The TAB is a statutory corporation. The minister of racing is responsible for appointing the organisation's directors but the TAB must distribute all net profits after tax to the Racing Industry Board. However, the government provides an implicit guarantee to the organisation. These arrangements, in which accountabilities and returns are separated and shared between different parties, are unlikely to provide strong incentives for performance.

My view is that the TAB should be converted to a conventional company structure. The ultimate ownership of the organisation is in doubt with both the government and the racing industry having possible ownership claims. An option would be for the government to gift the shareholding of the TAB to the racing industry. An alternative would be for the government to privatise the organisation and return some of the proceeds to the industry. Privatisation would be likely to ensure that the TAB ended up in the hands of investors best able to maximise returns from the organisation.

It is interesting to consider the success of the TAB privatisations in Australia with the State of Victoria, and more recently New South Wales, leading the way. Similar moves are being considered in other Australian states. I understand the stakes offered at Friday night harness meetings in New South Wales have increased from $9,000 a race to $15,000 since its TAB was privatised. While Australian privatisations have been successful, it would be preferable not to grant the TAB any special monopoly privileges (as has occurred in Australia) as part of a privatisation package.

4 Conclusion

The arguments for deregulation of the racing industry are strong. Racing does not need to be run like a nationalised industry with its own restrictive legislation. The liquor industry also used to be entangled in repressive legislation which led to dysfunctional behaviour and stunted the industry's growth. There is now broad community agreement that moves towards treating it more like a normal industry have been for the better. The arguments for substantial deregulation of the gaming industry in general are also strong.

The racing industry has undertaken some micro-level reform in order to adapt. However, it has been insufficient to allow it to cope with changed circumstances. Deregulation in other areas of the economy has uncovered new opportunities that no one envisaged before the changes, even by those most enthusiastic about reforms. I believe fundamental changes to the way the racing industry operates are required and would have similar results.

While I do not have specific solutions to the industry's current problems, I feel certain that progress will require greater innovation and almost certainly new investment in facilities, promotion and market development. This will entail increased risk. The new thinking

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1 Grantmakers, *Bulletin of Health Philanthropy*, 10 February, 1997.

and risk taking will only emerge in racing if barriers to entry to the industry are removed and the excess costs of regulation eliminated.

In the current political environment, the initiative for change may need to come from the industry itself. There is a good case to be made for treating racing like a normal industry in respect of ownership, regulation and taxation. I welcome the fact that the industry is considering these issues and will be interested to see whether it decides to go down that track.

EDUCATION AND THE LABOUR MARKET

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE PAID PARENTAL LEAVE BILL

DECEMBER 1998

PAID PARENTAL LEAVE BILL

1.0 Introduction

1.1 This submission is made on behalf of the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand businesses. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 The Paid Parental Leave Bill proposes to make available a period of paid parental leave for employees. Relatively few contracts of employment in New Zealand provide for paid parental leave, which indicates that most employers and employees feel that it is a provision that is less mutually beneficial than other conditions of employment. Now that restrictions on employment contracting have been liberalised under the Employment Contracts Act 1991 there is nothing to inhibit the inclusion of such provisions in contracts in place of other conditions. From an employer's point of view, such a provision may be a good investment in the interests of retaining staff and avoiding training costs. From an employee's point of view, the ability to take paid parental leave may be preferred to higher wages. Whether such considerations and preferences apply can be sorted out quite readily between the two parties. There is no reason to believe that mutually beneficial contracts cannot be agreed because of the relative bargaining position of the parties. Neither party has any systematic advantage, particularly in an environment in which moves towards full employment are not blocked by labour market rigidities. No such factors prevent employees from negotiating higher wages, more assistance with transport, or improvements in holiday entitlements, employee superannuation, health insurance or other conditions of employment in a healthy and growing economy. Parental leave arrangements should be a matter to be freely determined by the parties directly involved.

1.3 As living standards rise in a growing economy and as higher levels of employment are reached, there may well be stronger incentives on both sides to negotiate paid parental leave provisions. Australia and the United States, two countries with substantially higher average incomes than New Zealand, do not have mandatory paid parental leave but in Australia, for example, it has been reported that paid maternity leave is available in 34 percent of workplaces and paid paternity leave in 18 percent. There is no case, however, for state intervention to mandate such provisions, which are unlikely to conform with the preferences of the employment parties. Less skilled and less productive – and hence lower paid – workers in particular are much more likely to prefer higher wages rather than a lower wage/paid parental leave trade-off.

1.4 The Bill does not mandate a paid parental leave provision in employment contracts but rather imposes a payroll tax, the proceeds of which would be used to fund parental leave taken by qualifying employees. However, the effects would be similar. In addition, it raises the basic issue of why people who choose not to have children or are unable to do so, those who opt not to take such leave and the self-employed should be obliged to pay for the choices made by others.

1.5 The case for overriding the preferences of those directly involved in the workforce and applying an employment tax is unclear. Three possible aims suggest themselves:

- to enable people to withstand the impact on their finances of childbirth and consequent interruptions to employment;

- to encourage mothers (in particular) to remain with their children for a period rather than working; or

- to encourage women to return to the workforce after caring for children.

In each case, however, mandatory paid parental leave is not an appropriate method of achieving the aim.

1.6 If the aim is to enable people to cope financially with interruptions to their employment, paid parental leave is an inequitable and wasteful way of doing so. Qualification is not on the basis of need but status. Thus self-employed people, including those on low pay, will not qualify, but highly paid employees will (even if only up to a maximum). The proper way to deal with this problem, if it were regarded as a social policy priority, is through targeted welfare assistance.

1.7 If the aim is to encourage mothers to remain with their children, a wider view needs to be taken of taxation and government expenditure. As government expenditure has absorbed a larger and larger share of national income, tax rates have risen and in many families both parents have found it necessary to engage in paid work. Thus in 1960 the average wage earner paid no income tax. Today the average wage earner pays approximately $10,000 per year in income tax and the average wage earner's spouse goes out to work for a total of $10,000 after tax. Many mothers, in particular, may have had little choice but to enter the labour force because of today's much higher levels of government spending and taxation. The best approach to this problem is to reduce public expenditure and the burden of taxation, not to increase them.

1.8 If the aim is encourage women to return to the workforce, a much more flexible approach must be taken. For example, some women on maternity leave value part-time work that can be done at home. In this way they can maintain their skills and self-confidence. The arrangements that can be made will vary with the kind of work undertaken and the skills of the individual. The well-publicised parental leave provisions made available by some New Zealand firms are much more sophisticated than a one-size-fits-all parental leave payment, and make provision for female employees to remain in touch with work in a way that suits their individual circumstances. The imposition of paid leave, which appears to assume that employees earn nothing while off work (though that question is not dealt with in the Bill), would result in inflexibility that may prevent employers from taking imaginative steps to retain employees.

2.0 Statutory intervention in conditions of employment

2.1 There is now widespread support for a broad-based, low-rate tax system rather than one riddled with tax concessions. Such concessions impose compliance costs and have dynamic effects, many of which are unpredictable and undesirable. Once introduced, concessions tend to multiply as different interest groups use one precedent to apply pressure for other concessions that benefit them. In the end numerous such concessions result in money being churned from group to group while a relatively high tax rate has to be imposed on those who do not enjoy special privileges.

2.2 Similar arguments apply to statutory interventions in employment arrangements that favour particular groups of people or particular activities. They will impose compliance costs and have unintended effects over time. Furthermore, they will encourage demands for other such entitlements. In the end, wages generally will be depressed by the need to provide a complex system of allowances and entitlements. Whatever the short-term benefits from such allowances to particular people, the distortions they create make employment arrangements less flexible and productive and reduce overall income levels.

3.0 Who pays?

3.1 There are various ways that parental leave could be paid for. Each has different effects. Although the Bill makes detailed provision for a levy and a centrally administered fund, alternatives have already been canvassed in public debate.

Employer pays

3.2 It would be possible simply to require that employers grant their own employees paid parental leave. This would obviously impact severely on those who employ large numbers of women of child-bearing age, and would probably discourage employment of women in that age group. It would also create severe difficulties for many small and growing businesses – as indeed do the current mandatory parental leave provisions.

Levy on employees/employers

3.3 This is the method adopted in the Bill. It amounts to a payroll tax. Any such payroll tax is bound to have unfortunate dynamic effects, such as reducing employment overall and encouraging employers to change to contracting, in which case the contractors may actually have less job security and other benefits than they do now as employees. A moral hazard problem would arise. Some employers would encourage employees to claim the leave since their cost is unaffected. The provision that the levy is not to be charged to employees is delusional. In the medium term the cost will primarily come from the wage bill, or fall on consumers. This is discussed further below.

General taxation

3.4 This method has been recommended by the Labour Party. If adopted, the benefit would have to be made available to everyone; it would be blatant discrimination if a benefit funded from general taxation were only available to a single category of people, namely employees. The provision would amount to a universal welfare benefit and the appropriate question is whether such a benefit would be a priority in terms of general social welfare policy. The answer to that question is certainly 'no'.

3.5 Both the employer levy, and the proposal that the benefit be paid for from taxation amount to saying that those who have children from now on will be subsidised, regardless of their financial circumstances, by many people who are less well-off than themselves, by people who have already had children, by people who choose not to have children and by people who would willingly make financial sacrifices in order to have children but cannot. This is inequitable.

4.0 The real costs

4.1 The Council of Trade Unions (Angela Foulkes, *Dominion*, 11 September, 1998) has argued that paid parental leave would not "take money out of the economy" but merely "move it from place to place". If this view were correct, it implies that the proposal would involve no net benefits to society but merely a redistribution of income. But income cannot be redistributed without having effects on the incentives to produce income in the first place, and the reality is that the overall level of national income would be reduced because the labour market would operate less efficiently. Moreover, there would be the significant additional costs of administering and complying with a new payroll tax.

4.2 It is also clear from the same report that the Council of Trade Unions believes that income would be redistributed at the expense of employers. However, it is idle to believe that a transfer of wealth from employer to employee can be effected in this way even if it were judged to be desirable. The market for investment is highly competitive, and if returns on investment are reduced people will invest less or remove their money from New Zealand. There will be a one-off effect on those employers who currently have contracts of employment that would be unilaterally and retrospectively changed by the legislation. Thereafter, companies will take the cost into account when calculating their employment costs for future years and the money will come either from reduced wages, reduced wage increases or reduced employment. The only alternative is that the costs are passed on to consumers, which is likely to happen only in the non-traded goods sector of the economy or where competition is, for some reason, weak.

4.3 Ms Foulkes shows a glimmer of understanding of where the ultimate incidence of a payroll tax would fall when she says (in the same report) "The scheme should not just become a charge on employees, as [Accident Compensation Corporation] ACC had become". But that is exactly what will inevitably happen in an open, competitive economy. Income will not be shuffled between employers and employees but largely *between* one employee and another, *within* the same employee's remuneration package, or *at the expense of* the unemployed. Moreover, as a tax for funding a social policy intervention, a payroll tax of this type is an inefficient tax. New Zealand had a payroll tax in the Muldoon era but it has long since been scrapped in favour of a tax system based largely on less distorting income and consumption taxes.

4.4 There will also be dynamic effects from a mandatory paid parental leave intervention, some of which cannot be predicted. For example, it is likely that prospective parents who would not qualify for parental leave will alter their behaviour so that they do, for example by remaining with an employer and not having a baby until a year's employment is up. In this way and in others the group to be granted paid leave will expand and, as is invariably the case, the total expenditure on paid parental leave will be higher than expected.

4.5 There are further deadweight costs to be taken into account. The Bill would be one more complication to employing people and negotiating contracts. Because of complex holidays legislation, all labour lawyers know that shortly before a statutory holiday they will receive numerous telephone calls from employers seeking advice on their obligations. Likewise interventions of the sort proposed in the Bill would create a need for employers to use lawyers and employ human resources specialists, and for employees to use agents such as unions to represent them. Indeed, this is one of the reasons why unions lobby for complex statutory arrangements rather than simple contracting opportunities. Ensuring that employment arrangements comply with complex legislation requires the expenditure of resources, human and financial, that could have been employed productively and discourages job creation.

5.0 Conclusion

5.1 Mandatory paid parental leave is an idea whose time has long since gone. Voluntary agreements that include parental leave will be made in today's more flexible labour markets in situations and on terms that are mutually beneficial to firms and their employees. This proposal attempts to take us back to the days of detailed statutory interventions in employment conditions and personal financial arrangements. It is the equivalent of a tax concession that is available only to a particular class of people and paid for by all others. It will have a destabilising effect on employment law and encourage the proliferation of statutory interventions in employment conditions. Supporters of the idea have admitted that there is no net benefit to the community from the proposal and merely a redistribution of income, but they have overlooked the fact that by imposing costs and distorting employment arrangements economic and employment growth will suffer. Moreover, it is highly unlikely that the intended redistribution of income would be equitable.

5.2 We submit that the proposal is without justification and that the Bill should be abandoned.

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IS THERE A VIABLE ALTERNATIVE TO STATE FUNDING, REGULATION AND OWNERSHIP OF NEW ZEALAND UNIVERSITIES IN THE 21ST CENTURY?

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IS THERE A VIABLE ALTERNATIVE TO STATE FUNDING, REGULATION AND OWNERSHIP OF NEW ZEALAND UNIVERSITIES IN THE 21ST CENTURY?

In a lecture given at the University of Auckland earlier this year [1998], I commented that the record of New Zealand governments had been to respect academic freedom, despite their extensive involvement with the university system, and that the more obvious threats to freedom of inquiry and expression were coming from within the institutions themselves. But I also warned that future governments may take a less benign attitude to university autonomy. Like their counterparts in Australia and the United Kingdom, they may one day insist, as owners and funders, on a greater level of control. I suggested that university academics should think about ways of protecting academic freedom by moving towards a more diverse higher education system, such as exists in the United States, which has a mixture of state and private, non-profit and for-profit institutions. However, stronger protection of academic freedom is only one of the possible reasons for moves in this direction, and by no means the most important. So I welcome this opportunity to speculate further on this topic.

Some preliminary observations are in order. First, for most of their history universities have typically been private institutions. They began as religious institutions, and the churches continued to be the main provider of higher education until well into the nineteenth century. As well, universities benefited over the centuries from state patronage. But only in the twentieth century did governments in New Zealand and elsewhere become involved with the funding, regulation and ownership of universities in a pervasive way.

Secondly, although such state involvement is common and widespread, in several countries many, sometimes most, universities are private. In Japan, 80 percent of students go to private universities; in Brazil, 60 percent. The best-known private university system is that of the United States. Although it caters for less than a third of tertiary students, it includes some of the country's most prestigious institutions, the so-called Ivy League group. Private universities are emerging also in our part of the world. Australia now has four such institutions – Bond, Notre Dame, Melbourne Private and the Australian Catholic University. New Zealand has as many as 800 registered private training establishments (PTEs), ranging from the Auckland Institute of Studies to colleges of language, interior design, hairdressing and so forth. They are typically small institutions, with an average enrolment in 1995 of only 138. New Zealand and Australian governments have required their state universities to raise the level of private funding and they have introduced tuition fees over the last decade, though a high level of state subsidy remains in both countries, at least for domestic students. In addition, universities may raise private income from gifts or from selling their research services to private clients; the University of Canterbury has substantial endowments, while Lincoln University derives nearly half its income from private sources.

My third preliminary observation is that, in the private tertiary sector, a perceptible trend exists towards the for-profit model and away from the non-profit model. The Auckland Institute of Studies is a for-profit organisation. Chile and the Philippines have sizeable for-profit tertiary sectors. Several American universities are profit-making institutions. The DeVry Institute has traded its shares on the New York stock exchange since 1991. It has 27,000 students on 13 campuses. Tuition fees account for over 90 percent of its income, and it is reported to be able to provide a Bachelor of Science degree for half the cost of many state universities. The recently established for-profit University of Phoenix already operates in a dozen locations and on the Internet; with nearly 70,000 students it is one of America's largest universities. Of Australia's private universities, the most recently established – Melbourne University Private – is for-profit. I will come back to this example later, since it has an innovative structure that suggests a promising transition path for the privatisation of state universities.

These preliminary observations permit a first answer to the question posed in the title of this address. Viable alternatives certainly do exist to state funding and ownership of universities – that is a simple statement of fact. The important and interesting issue is whether these alternatives are preferable to the prevailing state model. It needs to be analysed under the three headings of funding, regulation and ownership as these are essentially independent issues and a variety of combinations of state involvement is possible. I will discuss each in turn.

First, funding. The New Zealand Business Roundtable re-examined the issue of government finance for higher education in a submission last year to the government's Tertiary Education Review. As we see it, government subsidies are not to be justified merely in terms of increasing participation in higher education for its own sake; given that resources are scarce, it is quite possible to have too much higher education in the sense that society would have to forgo other goods that it values more highly at the margin. Rather, any subsidy needs to be subjected to the normal tests that are applied to government spending: does it promote efficiency or equity? More specifically, does it improve on the outcomes in terms of efficiency and equity that would emerge in the absence of a subsidy? Our analysis suggests that present levels of subsidy are too high and not well targeted, and that they encourage an inappropriate pattern and level of offerings.

The efficiency arguments for government subsidy for higher education revolve around the alleged positive externalities of such education and possible deficiencies in capital markets. If too many of the benefits of higher education accrue to beneficiaries who cannot be made to pay for them, less higher education may be produced than is desirable from the community's point of view; while if capital markets are defective, some would-be students will be unable to raise the funds they need to buy their tuition or to maintain themselves throughout their studies.

Neither argument is very persuasive. Research in education has shown that the benefits of higher education are largely captured by students themselves in the form of the higher lifetime incomes that their qualifications command; the private incentives to obtain a tertiary qualification should be sufficient to ensure that something close to an optimal amount of higher education is produced. There is a stronger case for government subsidies for education at lower levels of education where the positive externalities may be greater.

As for capital market deficiencies, it seems implausible to argue that New Zealand's deregulated and competitive finance industry is unable to manage loans to most promising students or to find appropriate collateral among parents, potential employers or sponsors. Similar problems of lack of reputation and collateral face young people who want to establish a business. In other countries, support from parents rather than other taxpayers is often a prime means of obtaining a tertiary qualification. Part-time and vacation employment are other options.

In respect of equity considerations, the main point to be made is that blanket subsidies are inequitable in that most university students come from middle-class rather than low-income families and most go on to earn higher incomes than the average taxpayer in later life. Tuition subsidies are in fact a major example of middle-class welfare in New Zealand and in general a transfer from poor to rich. If there are to be subsidies, they should surely be concentrated on students from low-income families who may otherwise be unable to access higher education. Even in this case it has to be recognised that such subsidies go to people from low-income backgrounds with the greatest innate abilities and the best life prospects; those with less ability who struggle at lower levels of education are arguably still more deserving of assistance.

The Business Roundtable concluded that the efficiency argument for government funding pointed to a subsidy based on the public good element of courses. Universities should be required to assess this element just as local government is now required to assess the public and private benefit elements of its services, but we suggested that on average it was unlikely to exceed 30 percent of tuition fees. The goal of equity would be best met not by universal subsidies but by targeting disadvantaged students. The government's loan scheme should be structured along these lines. In addition, assistance could be encouraged from private sources. Universities could call on foundations and individual philanthropists to offer scholarships to students who, for various reasons, may otherwise miss out on higher education. A general move away from state welfare, particularly to middle and higher income groups, with a lower structure of taxes would allow more scope for self-reliance on the part of families and more non-government funding for those needing assistance.

What about government subsidies for the research undertaken in universities? The standard argument is that these subsidies are also justified on the grounds that they promote positive externalities. But research does not automatically produce such benefits, and the fact that the outcomes of research cannot be known in advance is no argument for public subsidies. Where research leads to higher-quality teaching, the costs should be recovered through appropriate levels of tuition fees. Research that is independent of teaching should not be charged to students. Where lines of research are known to produce positive benefits that cannot be charged for, any subsidies for them should be rigorously determined and monitored through some method of performance measurement. As well, they should not be allocated specifically to universities but should be contestable by any institution that engages in research. Much university research funding already comes from contestable sources like the Public Good Science Fund that may award funds to bodies other than universities, such as the Crown Research Institutes.

Overall, it seems that universities could derive most of their funding from private rather than government sources without any loss of, and indeed with gains in, efficiency and equity. Efficiency is likely to be further enhanced by the greater competition that would emerge among universities if students paid for more of their tuition costs, leading to better cost control and monitoring, more flexibility and responsiveness in meeting student demand, more intensive use of assets, and more imagination in attracting bequests and endowments. Funding should, of course, be neutral between public and private institutions, and students should also have the choice of using their subsidies at overseas institutions. Such a policy would increase competition, which is seen by most observers as a key factor in the performance of the American university system.

To date there is little evidence that higher fees have unduly discouraged enrolment, no doubt because a tertiary education is a good investment for many people. At some point demand might well be sensitive to the fees that are charged, but participation rates are not a sound basis for judging subsidy levels. Like any other investment, investment in higher education should only be undertaken if the returns exceed the costs, and some argue that currently students are being encouraged into higher education who are not suited to it. The argument for subsidies must come back to efficiency and equity considerations.

The benefits of 'privatising' much university funding, then, are pretty clear-cut in my view. I believe the same can be said of the case for removing much state regulation of universities – the second dimension of state involvement that I have been asked to consider. What is involved here is not general workplace regulation – health and safety requirements, for example – but the role of the government in policing entry into the tertiary education market, determining rules for state funding and certifying the qualifications that institutions confer.

In New Zealand, entry into the tertiary education market is strictly regulated. The name 'university' is protected by statute. An institution can only offer a degree if it meets the approval of the New Zealand Qualifications Authority (NZQA) and ensures that its teachers are engaged in research. It is proposed to formulate and adopt a minimum quality standard that is consistent with international standards. At first sight, such regulation seems benign. Potential students appear to face serious difficulties in gathering and evaluating information about the array of qualifications available from tertiary institutions and in judging how they compare internationally: does not this call for well-formulated regulation to provide assurance of quality?

However, consider some elementary axioms of the economics of information. First, information is costly to provide and to seek; producers therefore face a rational incentive to provide, and potential consumers to seek, only as much information as suits their purposes. If those incentives are absent, it is just as likely that too much information will be produced as too little. Secondly, well-known voluntary mechanisms have evolved to meet the demand for information, such as advertising, the use of brand names, reports by consumer organisations, and membership of associations that attest to quality; and successful producers earn invaluable reputations that spread by word of mouth. Thirdly, not all consumers need be well informed for a market to be efficient. If some consumers 'comparison shop' intensively and choose providers in the light of their findings, all providers will be conscious of the effects of choice and competition and other less well-informed consumers will benefit from the search activities of others. All of these mechanisms are at work in education markets.

It is therefore far from self-evident that government certification and accreditation of tertiary institutions are necessary, or that government regulation can rectify any problems at acceptable costs. Indeed, government regulation can *reduce* information. Ten years ago, the Australian government ended its 'binary system' of tertiary education, which usefully distinguished between the academically inclined universities and the vocationally and technically oriented 'colleges of advanced education' (what we call polytechnics). Under the current 'unified' system, the colleges of advanced education have been renamed 'universities', thus notionally raising their status but creating uncertainty about how their products compare with those of the original universities. The market soon rectified this example of regulatory failure: Australia now has not one but two well-regarded, commercially produced, annual guides to the universities.

Artificial entry barriers and regulated definitions of quality can be serious impediments to innovation and to the efficient evolution of markets for tertiary education. They are bound to reflect the views of existing suppliers of tertiary education, enabling them in effect to form a cartel that vetoes competitive threats to its members and encourages new entrants to conform with established models. Take the requirement that teachers should engage in research. This reflects the traditional career path of the tenured university academic, who combines teaching with research. But surely a tertiary institution should be permitted to allocate gifted teachers to teaching only? Of course teaching benefits from research, but teachers can gain that benefit by reading the results of research undertaken by other staff. It should be up to each institution to choose how to pursue its goals and to deal as it sees fit with any consequent risk to the quality and reputation of its services. As it is, the regulations make it easier for the established institutions to continue rewarding research performance much more highly than teaching performance: a major manifestation of producer rather than consumer sovereignty.

The deeper problem here is that 'quality' is a highly subjective concept, perhaps impossible to capture in any simple, unambiguous definition, and its meaning varies according to the purpose for which it is used. The assumption that quality *can* be authoritatively and clearly defined reflects the conviction, common in all the professions, that quality should be determined by the most experienced and successful practitioners. One problem is that most students are not aiming to become full-time practitioners of the subjects they study. They are studying for diverse purposes: to enhance their earning power, to change their occupations, to improve their minds, or just for the personal enjoyment of study. Different criteria of quality may be appropriate for each of these purposes. There are widely different quality standards in the American higher education market, and quality cannot sensibly be evaluated independently of cost – what matters to consumers is *value*, the quality/cost combination. A deregulated system would allow these various factors to become articulated and monitored, so enhancing the accuracy of the signals in the tertiary education market. As it is, the uniform qualification system inhibits the natural segmentation of this market, and so passes much of the cost of seeking and supplying needed information to the wider society.

It is simply not plausible to argue that a single agency, the NZQA, can do a better overall job of replicating and processing this sort of information than the market. But if the system were deregulated, the NZQA could survive on a voluntary basis if its services were valued and tertiary institutions found them to be a useful way of signalling their standards and reputation. However, those institutions would be free to seek validation from other bodies, international as well as domestic, and would be likely to do so especially if they wished to pursue multiple segments of the higher education market. New institutions would be free to offer degrees and to seek validation from other bodies, or none at all if they preferred to rely on other quality controls. The result would be a much more diverse system, with institutions facing incentives to realise their existing comparative advantages and being free to invest in new ones, as opposed to the overwhelming incentives under the present homogenous system to replicate the norm.

The final dimension of intervention that I have to address is ownership. Here there are two basic issues. The first is whether the state needs to be a provider of higher education services. The second is whether to adopt a non-profit or a for-profit form of organisation if state institutions are moved to the private sector.

On the first issue, I find it very hard to find compelling arguments for government ownership of tertiary institutions. We have seen that private universities have proved themselves to be perfectly viable, even under unfavourable terms of competition with state institutions. To be sure, private institutions are not uniformly better than state institutions, but this observation is not a reliable guide to policy, particularly when competition has taken place on an uneven playing field. We need to see whether there are sound public policy reasons for the state being an owner.

It is difficult to see any equity objectives that require state ownership. Equity concerns can be readily catered for through funding strategies and, if necessary, regulation. Any desired level of subsidy can be provided to students enrolling at competing private institutions.

Efficiency objectives would seem likely to be better achieved through private ownership. Governments can face conflicts of interest between their ownership and funding roles. They find it hard to allow institutions that they own to fail, regardless of their performance. It is difficult for governments to undertake effective monitoring, particularly of standards of teaching and research. Attempts to do so are likely to become costly and intrusive, and perhaps threaten institutional autonomy and academic freedom. Autonomous institutions would have a greater capacity to plan long-term strategies whereas this capacity is limited for state institutions by changes in governments and government policies. Institutions with greater autonomy would enjoy greater freedom in employment and remuneration arrangements and asset management. There would also be stronger incentives for performance, provided sound governance structures were established. Current governance arrangements involving councils of an unwieldy size and politicised representation of insider groups are weak, but this problem can only be remedied under state ownership by moves to downsize councils and place more reliance on owner appointments and co-opted members, which university communities resist. Arguments that an abandonment of state ownership would mean an end to a traditional academic and 'public service' culture that would be upsetting to university staff do not seem persuasive.

For these kinds of reasons, some of which have motivated moves towards privatisation of other state-owned organisations, I believe we are likely to see governments reconsidering their ownership of universities and other tertiary institutions. Sweden is one country that has already privatised two of its tertiary institutions, one of which is a leading university, partly in the interests of encouraging greater diversity, competition and innovation in the tertiary sector.

The second and more interesting question, on which I have an open mind, is whether state institutions should be moved into a non-profit or for-profit form in the private sector. Around the world, the non-profit form has been the more common model. This may, however, have more to do with the historical origins of universities, to tax concessions granted to the non-profit form and to non-neutral government funding policies than to inherent aspects of their performance. One argument that is made for maintaining some existing non-profits in a North American context is that alumni donations are an important source of funding and that these would dry up if residual owners were able to appropriate profits. However, this argument seems barely relevant in a New Zealand setting where donations are a minor source of funding, where there is more emphasis on teaching than research, and where the logic of donations is dubious given existing government funding policies. It would only become more compelling if the case for government funding of universities on public goods grounds were called into question.

From the point of view of efficient performance, there are some obvious weaknesses with a non-profit model that would typically take the legal form of a trust. New Zealand experience with trusts in industries like banking, liquor retailing and electricity suggests their performance is typically inferior to their normal commercial counterparts. Monitoring of trusts is difficult, and they are not subject to disciplines such as the threat of takeover – they share these disadvantages with state-owned institutions. As a result, managers and staff may be able to enjoy the 'quiet life' and there may be less entrepreneurship and innovation. A further point is that, contrary to some popular assumptions, non-profit universities do not face a lower cost of capital through not having to pay dividends; the opportunity cost of capital to them includes a normal profit and charges for tuition or other services must reflect this element unless they are subsidised from other sources.

It is the recognised disadvantages of the non-profit model, which may also include problems of capital raising, that are generating so much interest in the emergence of the for-profit universities, like the DeVry Institute and the University of Phoenix mentioned earlier. Tertiary education is an expensive, labour-intensive business, and its *modus operandi* has remained remarkably unchanged for decades, even centuries. However, modern communications technology, especially the Internet, is creating opportunities for all that to change, and the for-profit model is the one that seems to be discovering them fastest. The global reach of the Internet means that no university is safe from the competitive threat posed by the new on-line universities. A possible future of this kind was sketched by Peter Aranson of Emory University, Atlanta, in a recent paper entitled 'Wither the Non-profits?':

> It is a frightening prospect to most university administrators and faculty, but the age of for-profit colleges and universities has begun. Imagine a national university, or even a regional one that offers courses to students by videotape, CD, over the Internet, or in rented halls. The university could locate the very best lecturers in the world and commit their lectures to an electronic medium, with total, centralised multimedia support. It could establish telephone, e-mail, learnlink, and chatroom support … .

> Notice what this hypothetical example *does not* include: dormitories, food services, counselling offices, gyms, chaplaincy staff, offices of affirmative action, students organisations that all students must support, massive layers of administrative bureaucracy, libraries ... .
>
> Notice what this hypothetical example *does* include: careful selection of faculty and student assistants for their teaching skills, close monitoring of course content and quality of lectures, careful choice of teaching materials and other indicia of performance, open admissions ... .
>
> This vision no longer remains hypothetical. It is happening now.

This news will not necessarily be welcomed by many, perhaps most, academics. But if for-profit universities are finding ways to cut costs, remuneration for their teaching staff might rise above prevailing levels in state and non-profit universities, and opportunities for staff to become shareholders would open up. Some university staff in mid-career, who have watched their salaries fall relative to the average and are wondering whether they should ever have embarked on academic careers, must surely see opportunities as well as threats from the arrival of the profit-making university.

One way of facilitating the transition from state to private for-profit status has been demonstrated by Melbourne University Private. Launched earlier this year, Melbourne University Private has been promoted by the University of Melbourne – probably Australia's leading university – in response to growing central government control over Australia's state-financed universities. It is essentially a for-profit adjunct to the University of Melbourne. It draws on private finance and has its own campus. But its undergraduate and graduate awards will be certified by the University of Melbourne, and it has negotiated access for its students to the University of Melbourne's extensive amenities. It will derive income not only from its degree courses in select subjects but also from short, customised professional training courses, research for government and business, and consultancy services. By buying access to an established university infrastructure and a well-regarded brand name, Melbourne University Private has overcome many of the policy-induced barriers to entry into the tertiary education market. As well, it will provide opportunities for staff of the University of Melbourne to undertake additional work as contracting teachers. It has naturally aroused controversy within the academic community, but it seems well placed to survive and prosper.

There is no need to advocate a one-size-fits-all solution to the ownership problem. If, as I see it, there are advantages in moving away from state ownership, some institutions or parts of them (such as Master of Business Administration (MBA) programmes) may be more suited to a for-profit model while others may work better as non-profits. One thing I am very clear about is that the for-profit model provides much stronger drivers for efficiency and would offer a better deal to students from the point of view of costs, as the US examples demonstrate. If students' associations were seriously concerned about costs they would do well to look hard at this option, instead of engaging in mindless rhetoric about the 'marketisation' of education. The only counter-argument I have heard, and about which I retain an open mind, is that private ownership would somehow undermine a university's academic mission. This is a nebulous assertion, and needs to be explained in a precise way and to be tested if it is to be taken seriously.

My conclusion, therefore, is that as a matter of both fact and logic there are viable alternatives to state funding, regulation and ownership of New Zealand universities. In my opinion they all offer advantages over present practices. As I see it, universities face a basic choice. They can cling to government ownership, keep advocating high levels of government funding and tolerate indifferent government regulation. In this scenario I believe they will face pressures for more intrusive monitoring and greater controls over time as governments respond to justifiable pressures from electorates to be more accountable for the huge resources going into higher education. Alternatively, they can opt to progressively let go the apron strings and chart their own destiny.

> Universities should be exciting and innovative organisations, yet too often in my experience staff morale is low, the culture is conservative and resistant to change, good academics are frustrated by poor administration, and academic careers are becoming less attractive than opportunities elsewhere. For their part, students are facing costs of tuition that might be substantially reduced if organisations faced different incentive structures. With increasing tertiary enrolments and tax pressures on governments, universities are not likely to find governments willing to increase student subsidies, nor would this be justified. For these reasons I believe that all parties have a stake in seeing alternatives to current arrangements are vigorously canvassed in the period ahead.

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE 1998 REVIEW OF THE STATUTORY MINIMUM WAGE

OCTOBER 1998

THE 1998 REVIEW OF THE STATUTORY MINIMUM WAGE

In broad terms the argument for raising the adult and youth statutory minimum wage rates is that it would increase the incomes of low-wage employees and produce a fairer distribution of income. People higher up the wage scale may also enjoy smaller wage gains as a consequence of increased demand for substitutes for low-productivity labour. However, if minimum wages inflict losses on others in society, for instance by denying a job to low-productivity workers, then raising minimum wages may not be consistent with the objective of greater equity and improvement in overall welfare in society. A further consideration in assessing the merits of raising minimum wages is whether there are other policy instruments better suited to improving the welfare of low-wage employees.

The first part of this submission explains why a minimum wage will inflict losses on some groups, notably less able people in the workforce. Part II outlines issues to be considered in assessing whether the gains to the beneficiaries are sufficiently great to justify the losses inflicted on the losers. Part III summarises the case for opposing any increases in minimum wages.

I LOSSES ASSOCIATED WITH THE MINIMUM WAGE

1.0 Labour market participants

1.1 Introduction

As is well known, conventional economic theory predicts that raising a statutory minimum wage above the market-determined minimum wage will reduce the numbers employed and the aggregate hours of employment. If so, although the incomes of low-wage earners who retain their jobs can be expected to increase, the market earnings of those who lose their jobs fall dramatically – to zero. The main claims of those who oppose raising minimum wages (and, indeed, favour their abolition) is that the losses imposed on the latter outweigh the benefits accruing to the former and that overall economic efficiency and national income are reduced through disemployment and other effects. The validity of this claim depends on whether minimum wages do cause a loss of low-wage jobs and, if so, on:

- the numbers precluded from employment;
- the nature and severity of the losses; and
- other effects of minimum wages.

These issues are examined in this section.

1.2 Do minimum wages preclude people from jobs?

The conventional view that setting a higher effective minimum wage will preclude at least some people from jobs has been challenged in recent years by proponents of the "new economics of the minimum wage" (hereafter 'the new view') who claim, primarily on the basis of recent statistical studies, that the effects on employment may be close to zero or even positive (see, for example, Card and Krueger, 1995; Chapple, 1997). The following theoretical points are relevant to assessing the merits of the two views.

The conventional view is underpinned by two main propositions:

- Raising the minimum wage tends to increase the costs of producing goods and services that require relatively intense use of unskilled labour in production. In the case of non-traded goods and services that are unskilled-labour-intensive (eg fast food products) this tends to raise their prices relative to prices of other goods, thereby reducing the quantities consumed and the quantity of unskilled labour hired to produce such goods. Production of unskilled-labour-intensive traded goods and services also tends to decline because the profitability of producing them declines.

- Producers of both traded and non-traded goods tend to substitute other inputs for unskilled labour in production processes.

The new view is underpinned by two main theoretical constructs. The first derives from conventional theory that, within a certain range, setting a minimum wage will induce a monopsonist to increase the quantity hired of a given type of labour.[1] The validity of this theory is generally accepted. However, because the conditions for the existence of a genuine monopsony are extremely rare, the conventional view is that it is not a sound basis for expecting an increase in a statutory minimum wage to result in anything like a measurable *increase* in total employment of low-skilled labour. In essence, what is at issue is whether a firm such as McDonald's might be sufficiently dominant in the market for youth labour in an area to behave *as if* it were a monopsonist. While careful consideration of the conditions required for the existence of monopsony power suggests that this is unlikely be the case, for a variety of reasons it is difficult to find the kinds of evidence required to resolve the issue beyond dispute.

A second theoretical construct used in support of the new view is that the 'shock' of an increase in a minimum wage can induce employers to find ways of improving labour productivity to an extent that enables them to profit by increasing the quantities of labour hired. This is essentially an *ad hoc* explanation that is, at best, barely plausible because it is tantamount to assuming that previously employers failed persistently to perceive and exploit opportunities to increase profits.

We conclude that, in contrast to the common-sense propositions underlying the conventional view, the theoretical underpinnings of the new view are both contrived and unconvincing. Similar conclusions are to be found in the recent economic literature (see, for example, Hamermesh 1995, pp 837–838; Lewis 1997, pp 6–7). In summary, there are convincing theoretical reasons for expecting that minimum wages set above the market wage that would otherwise apply will exclude low-wage people from jobs.

1.3 How many people might lose jobs?

The conventional view, based on empirical studies stretching back over many decades (predominantly from the United States, but also from other industrialised countries), is that a 10 percent increase in the minimum wage can be expected to reduce the employment of low-wage workers by something of the order of 1 to 3 percent (ie the elasticity of demand for low-wage labour seems likely to be in the range - 0.1 to - 0.3 percent). On this basis an estimate of the effect of raising the adult and youth minimum wages in New Zealand by, say, 5 percent would be the reduction in employment of youths and young adults (the 15–19 and 20–24 age groups) by perhaps 1,000 to 5,000 depending on the numbers employed in these age groups at the bottom of the wage spectrum. Additional job losses could be expected in other adult age groups. In contrast, the new view is that the effect of raising minimum wages (up to some unspecified limit) would be close to zero and possibly positive. Which of these two views is most plausible?

The evidence from New Zealand is limited and ambiguous. Consistent with the conventional view, Maloney (1995) finds that a 10 percent increase in the adult minimum

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

wage only (ie holding the youth minimum wage constant), can be expected to reduce employment of young adults by 3.5 percent, and to increase employment of youths (because they become relatively less costly to employ). Chapple (1997) finds some evidence that is consistent with Maloney's estimates. However, his overall assessment of the evidence is "… a tentative working hypothesis … that increases in the real minimum wage have a minimal negative impact on employment rates …". This accords with the new view.

In assessing where the balance of evidence lies, the following points should be considered.[2]

- In 1996, by which time the great majority of labour economists (if not all) would have been well aware of 'new view' evidence and arguments, 87 percent of a random sample of 193 US labour economists agreed with the conventional view that "a minimum wage increases unemployment among young and unskilled workers". The median response was that a 10 percent increase in the teenage minimum wage would reduce teenage employment by 2 percent (Whaples, 1996). The median response from another 1996 survey of 65 US labour economists from 40 leading US university economics departments was that a 10 percent increase in the minimum wage would reduce teenage employment by 1 percent (Fuchs *et al*, 1998). Clearly, a great majority of US labour economists hold the conventional view that minimum wages reduce employment. In fairness, these same surveys showed opinions were about evenly divided on the desirability of increasing minimum wages, a finding which Fuchs *et al* (p 1393) regard as surprising given these economists' views on likely job losses.

- A study conducted by Deere, Murphy and Welch in response to the new view provides statistically robust evidence that raising the US federal minimum wage from US$3.35 per hour in 1990 to US$4.25 per hour in 1991 resulted in falls in teenage employment of 7.3 percent, 11.4 percent and 10.0 percent for men, women and blacks respectively (relative to *projected* employment at a wage rate of $3.35) and in employment of adult high school dropouts of 3.1 percent, 5.2 percent and 6.7 percent for men, women and blacks. They conclude:

  The regressions have no surprises. When the cost of employing low-wage laborers is increased, fewer low-wage laborers are employed (Deere, *et al* 1995, p 237).[3]

  Note that the study showed that disadvantaged groups bore disproportionately large shares of these job losses.

- In his recent survey of the international evidence on the effects of a minimum wage on employment, Murdoch University (Western Australia) economist Andrew Seltzer states: "The jury is still out, although the pendulum seems to be swinging back in favour of those who believe that the minimum wage does reduce employment at the margin. … The limited evidence from the United States suggests that the employment effects can be quite large for industries where the minimum wage really binds" (Seltzer, 1997).

- Leading advocates of measures to improve the earnings of low-wage employees clearly recognise that increasing a minimum wage may reduce employment. For example, in reviewing the minimum wage as an instrument for increasing earnings, Columbia University economist Edmund Phelps states:

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2 Given that there are sound reasons for expecting producer response to changes in wage rates to be similar across industrialised countries, it is appropriate to consider evidence from overseas. The bulk of this evidence comes from the United States.

3 These authors have now largely dropped out of the debate, almost certainly because they believe it to have been substantially resolved in their favour.

No economist I know of has suggested that wage rates of $4 an hour might be pushed up to $7 by means of a hike in the minimum wage without causing a major decline in employment among low-wage workers.

He goes on to state:

> … even if employers, in the face of a mandated wage increase, maintain their employment of their current low-wage employees, in whom they have invested something, they will look for ways to get along with fewer of them as these employees eventually move on. The long-run effects … [on employment] … might be much larger than those detected early on (Phelps, 1997, p 146).

Similarly, Harvard University economist Richard Freeman, a leading advocate of the minimum wage as a measure for improving the distribution of income, states:

> Absence of noticeable employment losses in these [recent] studies does not, of course, imply that minimum wages much higher than those observed may not risk large job losses nor that minimum wages may not cause employment disasters in particular sectors, such as apparel, or in particular firms (Freeman 1996, p 642).

Both Phelps and Freeman make the point that whereas the Card/Krueger estimates focus on short-term effects of higher minimum wages, there are well recognised reasons for expecting the longer-term effects to be larger – it takes time for responses, including changes in production technologies, to be implemented and ramify through an economy.

- Higher minimum wages increase the incentive for people such as students and married women to enter or re-enter the workforce (ie to become active participants in the labour market). Many of these people may be relatively highly productive employees and may, in effect, displace less productive workers. Thus, while the net effect of increasing a minimum wage on total employment may be small, the likelihood that it nevertheless precludes from employment substantial numbers who would otherwise have jobs should not be overlooked.[4] This is not in any way inconsistent with conventional theory. The important implication is that failure to detect a statistically negative relationship between a minimum wage and numbers employed cannot be assumed to be evidence that the minimum wage is not precluding people from finding jobs. As Neumark and Wascher state in relation to youth employment:

> … although minimum wages may lead to small net disemployment effects for teenagers as a whole, there are significant enrolment and employment shifts associated with minimum wage changes that should be of concern to policy makers (Neumark and Wascher 1995, p 248).

This is a possible explanation for the small estimates of aggregate job losses in Chapple (1997).

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4 Because the implications for policy-making are very different, it is important to distinguish between the claims that increasing a statutory minimum wage may *increase* employment (eg Card and Krueger, 1995, pp 79, 236) and claims along the lines that it is unlikely that a statutory minimum wage has a *large* negative employment effect (eg Card and Krueger, 1995, p 390). Whereas neither the theory nor the evidence provides convincing support for claims of the former kind (see, for example, Hammermesh, 1995, Lewis, 1996, Seltzer, 1996), claims of the latter kind are consistent with accepted theory and there is at least some plausible supporting evidence.

For a variety of reasons it is very difficult to devise statistical procedures that can be guaranteed to yield reliable estimates of the employment effects of minimum wages. This is reflected in the strong criticisms of econometric procedures launched from both sides of this controversy (see, for example, Welch 1995; Card and Krueger, 1995). However, the difficulty of devising statistical tests to 'prove' theories is not peculiar to the economics of the minimum wage. For example, it is doubtful whether anybody has produced an unambiguous econometric test of the proposition that reducing the tariff on an imported good will, except in certain unusual cases, increase a country's real gross domestic product (GDP). The reason this proposition is so widely accepted by economists is not that it has been confirmed conclusively by econometric tests but rather that the underlying theory is compelling and there is a lot of evidence, both statistical and direct, that is consistent with the theory. In our view the status of conventional minimum wage theory is comparable.

Finally, there is a tendency to *underestimate* the effects of prices on the quantities of goods and services demanded and supplied. This led the late Nobel laureate George Stigler, a master of irony, to propound the following 'law':

> … most people believe that all supply curves are completely inelastic and all demand curves are completely inelastic too!

Therefore, the common belief is that people respond little to price changes. A relatively recent manifestation of Stigler's law was the extent to which experts (including many economists) underestimated the effect of the substantial increases in oil prices in the 1970s on oil consumption. Thus organisations, including the US Department of Energy, Exxon, the US Central Intelligence Agency (CIA) and the US Congressional Research Service, made predictions in the late 1970s of world oil consumption in 1985 that turned out to be between *50 and 80 percent too high*. The reason was essentially that these forecasters grossly *underestimated* the extensive opportunities to economise in the use of oil in response to a price increase (van Vector and Tussing, 1987). Other evidence of the prevalence of Stigler's law are the numerous examples from many countries of widely unanticipated surpluses of stocks of agricultural products such as meat, dairy and wool resulting from artificially supported prices for such products.

In summary, although still controversial in some circles, our conclusion is that both the widely accepted theory and the balance of statistical evidence support the proposition that the most likely outcome of increasing a binding minimum wage rate is that employment will fall. Even if the negative effect is small it cannot be assumed that the number of people precluded from jobs is small because new, more productive entrants may displace people who would otherwise have jobs. In our opinion it would therefore be unwise to raise minimum wages in the belief that negative effects on employment will be minor or even positive, especially in the longer term. The fact that the predictions of the effects of changes in product and input prices have in the past often turned out to be too low is an added reason why it would be prudent to base decisions on minimum wage rates on the premise that higher minimum wages will preclude substantial numbers of people from obtaining jobs.

1.4 Losses imposed on people precluded from jobs

The main kinds of losses suffered by people who are precluded from employment or who lose their jobs are:

- loss of earnings and consequent reduced access to goods and services;
- loss of opportunity to acquire on-the-job training;
- loss of opportunity to maintain or establish a reputation as a good employee; and

- psychological stresses, including loss of self-esteem attributable to being without a job that may encourage dependency on welfare support.

The effect of earnings losses on access to goods and services can be expected to vary with circumstances including entitlement to the community wage, access to private financial assistance, age, composition of the household in which the displaced worker resides, regional differences in costs of living and differences in work-related costs (eg travel and clothing). For example, preclusion from a job by a minimum wage can be expected to constrain consumption for an adult with few assets and no access to private assistance more severely than a similar loss of income for a young university student living with their parents.

The cost of loss of opportunity to acquire on-the-job training is measured conceptually by the present value of the associated loss of future earnings over a person's working life. Although these losses are easily overlooked, in purely financial terms they may be high, to the extent of overshadowing the immediate income losses attributable to preclusion from employment, especially for a young person attempting to get a foothold in the labour market.

Loss of opportunity to maintain or establish a reputation as a good employee can be damaging because employers rationally tend to use a person's unemployment record as an indicator of labour quality. For example, where an employer cannot be sure of the reason that a job applicant was dismissed from a previous job, it is rational for them to assign a positive probability to unsatisfactory performance as the cause, even if a job has in fact been made unprofitable by a minimum wage.

Loss of self-esteem can be expected to reduce the prospect of finding a job, especially for people who remain unemployed for long periods. They become dependent on welfare and add to its costs. In December 1997, according to the Household Labour Survey, just over 57,600 people or 3 percent of the labour force were registered as being unemployed for at least one year. Raising minimum wages can be expected to further reduce the likelihood that these people will find jobs.

The last three kinds of losses are interrelated. Loss of reputation and loss of self-esteem combine to make finding a job difficult, which in turn precludes on-the-job training. Putative earnings losses from the combined effects of loss of reputation, loss of self-esteem and loss of training are likely to be especially high for young people who, by being priced out jobs by minimum wages, become discouraged job seekers. Moreover, they tend to be more severe for the least productive people – those who are at the lower end of the wage distribution because they lack education and training or because of innate characteristics which limit their productivity.

In summary, although it is natural to focus in the first instance on the welfare consequences of income losses, the interrelated effects of loss of self-esteem, loss of reputation and loss of training opportunities have additional debilitating effects on the lives of people precluded from employment by minimum wages.

2.0 Producers and consumers

The effects of an increase in minimum wages on producers and consumers can be expected to vary across industries depending principally on:

- the share of unskilled labour costs in total production costs; and

- whether the product is a traded or non-traded good or service (the main determinant of the extent to which cost increases can be passed on to consumers).

While no cost increase is likely to be viewed favourably by producers, because the wages of most workers will remain unchanged (or change by relatively small amounts) the effects of an increase in minimum wages on profits are unlikely to be large in most cases. This will be less true for traded-goods industries where producers cannot pass on cost increases to consumers because prices for their products are determined in international markets.

However, this does not preclude the possibility of significant effects on the profits of particular firms. For example, in parts of the agricultural sector, where unskilled labour costs may constitute relatively large proportions of total costs (such as fruit growing), some producers may experience substantial reductions in profits, especially if their ability to pass on costs to consumers is limited by competitive pressures from imported products. Importantly, since some of these producers may already have low incomes it is far from clear that increasing minimum wages will 'improve' the distribution of income or that it will be consistent with generally held notions of fairness.

Similarly, although the effects of an increase in minimum wages on the prices of most products can be expected to be small, prices for some non-traded, unskilled-labour-intensive goods, such as fast foods, may rise substantially. Effects of this sort were noted by some economists following the 10 percent increase in the minimum wage in 1997. Because some consumers of these products have low incomes it is again unclear that the impact of higher minimum wages will be consistent with either 'improving' the distribution of income or fairness.

II COMPARING BENEFITS AND COSTS

Besides considering the effect on economic efficiency and national income of altering market-determined wage rates, assessing the desirability of raising minimum wages also entails weighing the expected gains to the beneficiaries against the losses inflicted on the losers.

3.1 Assessing the worth of benefits

For a variety of reasons, people on minimum wages are not necessarily in a position of financial hardship and the benefits of minimum wage increases, as a poverty alleviation device, may therefore be limited.

- Although low incomes are a cause of hardship for some people, not all low-wage employees can be considered to be financially disadvantaged – some in the early years of their working lives can expect to have adequate incomes in the future (eg many students, apprentices) and some are members of households that are not financially stressed (those with spouses in paid work, young people). An analysis by the Treasury found that low-waged youth are spread relatively evenly across all household income bands. Those on the adult minimum wage were also found to be spread widely but with a tendency to be concentrated on the central quintile.

- Low paid jobs are, for most people, a stepping stone to higher paid jobs. For example, a recent UK study found that 55 percent of a random sample of workers in the bottom quintile of the earnings distribution had moved to higher quintiles two years later (Sloane and Theodossiou, 1996). In an analysis of income mobility in New Zealand, Barker (1996), reported that at least 25 percent of taxpayers in the lowest income quintile had joined higher income groups one year later. Similarly, although at any given time about 5 percent of the US workforce is employed at a minimum wage, about 60 percent of the workforce has been paid a statutory minimum wage at some time in their working lives (Card and Krueger, 1995).

- Low pay and financial stress may not be closely correlated. A UK study showed that less than 30 percent of people who were in the bottom quintile of the earning distribution in 1991 and still there two years later were from low-income households (household income in the bottom quintile). This suggests that income transfers effected by minimum wages may not be closely targeted on people from financially stressed households (Sloane and Theodossiou, 1996).

- Overseas research shows that hours of work rather than pay rates are a key factor affecting poverty. Lawrence Mead emphasised at the 1997 'Beyond Dependency' conference that 'non-work' rather than low pay was the main cause of poverty for the long-term poor in the United States. Research in the United States has shown that in 1954 two thirds of the heads of poor families were employed and almost a third were employed on a full-year and full-time basis. By 1995, only 52 percent of heads of poor families were employed and only 19 percent worked full-year and full-time.

3.2 Assessing the consequences of job preclusion

Loss of earnings can be expected to cause practical problems and stress for many of those deprived of jobs. The severity of the problems can be expected to depend on their circumstances, notably duration of unemployment, access to unemployment benefits, and access to private financial and other kinds of assistance.

- Based on a survey of 1479 unemployed people in the United Kingdom in 1973, Daniel found that "… financial considerations were paramount in determining the degree of concern about being out of work among the unemployed", with 72 percent of the 924 people who felt concerned about being unemployed regarding lack of money as the worst consequence (Daniel 1974, p 44).

The nature and severity of the personal and mental stresses attributable to being involuntarily unemployed varies presumably according to the circumstances and personalities of the people concerned. However, some notion of the severity of the stress of unemployment can be gleaned from the following observations, mostly from psychologists.

- Kelvin and Jarrett (1985, p 6) write of "… consistent evidence that human beings need a sense of purpose and structure to their lives; that the vast majority derive this purpose and structure very largely from their work; and that to be unemployed is therefore for most people deeply disturbing, distressing and debilitating".

- "In the eyes of the people who had experienced it, unemployment was seen almost invariably as unpleasant and sometimes highly distressing. Over half of those who had been unemployed at any time after redundancy described it as the worst thing they had ever experienced" (Westergaard *et al*, 1989, p 95).

- "The unemployed often become uneasily aware that as time goes on they develop a kind of inertia that is psychologically debilitating. They feel insufficiently stimulated and under-valued. The terms they use to describe their condition include 'depression', 'boredom' and 'laziness'. They feel increasingly that they are becoming not only occupationally, but psychologically deskilled" (Hill 1978, p 118).

- "Discussions of human consequences of unemployment are full of references to how it lowers self-esteem, saps self-confidence, undermines self-reliance, induces self-disgust, heightens self-consciousness, and so on – all of which cumulatively implies a profound change in the individual's self-concept" (Kelvin and Jarrett 1985, p 44).

- "It seems wholly likely that family life is shaken by unemployment – often to the point of disintegration – and we have evidence that points towards possible increases in divorce, domestic violence, abortions and unwanted pregnancies, parental and infant mortality, and morbidity in wives and children, as well as evidence of failure of growth in children" (Smith 1987, p 137).

- "In day-to-day practice, social workers observe that behaviour problems associated with stress and stress-induced disorders accelerate with unemployment. Recent research on social indicators bears out this observation. For example, child abuse, suicide, sclerosis of the liver (indicative of alcohol abuse), and cardiovascular and urinary diseases (indicative of too much stress) have been demonstrated to increase with increases in unemployment" (Keefe 1984, p 264).

- In a study of suicide and unemployment in Australia, Morrell *et al* (1993, p 755) conclude that statistical evidence "… supports the hypothesis that unemployment is significant as a predisposing factor for increasing the risk of suicide, especially for males". As Maley observes in commenting on this study, given that this is especially true for males in the 20–24 age group," … we have strong grounds for criticising public policies which are, predictably but avoidably, exposing thousands of young men to the kinds of anguish, idleness and despair that arise from unemployment and which, for too many of them, may have suicide as one of its consummations" (Howard *et al,* 1995).

3.3 Other considerations

Both the beneficiaries and the nature of the benefits resulting from an increase in a minimum wage are readily identified. Importantly, these beneficiaries *can readily identify themselves* and are therefore likely to be strong supporters of minimum wage legislation. In contrast, those who suffer losses as a result of an increase in a minimum wage *cannot be readily identified*. In particular, few, if any, losers can know with certainty that they are the victims of minimum wage legislation. A loser knows only that they do not have a job – the minimum wage legislation that may have caused this misfortune is only one of many imaginable reasons why they cannot find one. For these reasons popular support for minimum wages tends to be strong, while the plight of losers can be easily overlooked.

Apart from the risk of inflicting severe losses on people who are already disadvantaged, there are at least two other substantial reasons for opposing an increase in minimum wages. First, if only because the people precluded from employment cannot be identified reliably, the effects of raising minimum wages on the distribution of income and wealth cannot be reliably predicted. However, there can be no presumption that income transferred from owners of businesses and consumers to beneficiaries of higher minimum wages will be systematically correlated with ability to pay. Indeed, perverse effects on generally accepted notions of equity seem inevitable. For example, minimum wages can be expected to transfer income from people with low incomes who buy take-away foods to some young people employed in the industry who currently have adequate incomes and who may well expect to have relatively high incomes in later life (eg students, apprentices). Similarly, because many business enterprises fail, often with disastrous financial consequences for their owners, there will inevitably be cases where minimum wages transfer income from low-income employers to employees who are not financially stressed.

The second (and in our view more important) reason is that appropriately designed tax-financed income transfers are better instruments for achieving the objectives of a minimum wage. Moreover, whereas minimum wages achieve their objective by impeding the functioning of labour markets, appropriately designed tax-financed income transfers leave people free to use markets to search for and negotiate welfare-improving employment contracts with employers. In view of the nature and severity of the consequences of unemployment as sketched above, the significance of this cannot be overestimated. To deprive a person of the freedom to decide whether they would be better off with a job at a negotiated wage below a statutory minimum (possibly offering prospects of higher future wages) or without a job and dependent on the community wage is, in our view, a substantial injustice.

For these reasons we consider that efforts to improve the welfare of people at the lower end of the productivity spectrum should be shifted away from minimum wages toward income support measures financed by government revenue. The role of the community wage in determining the reservation wage and thereby ensuring a minimum level of welfare for *people with jobs* should be clearly recognised. Provided people are aware that the community wage is available, and absent deception and fraud, they will typically not accept a market wage and other conditions of employment that leave them worse off than being without a job and on the community wage. Thus, a safety net based on the community wage tends to equalise the welfare of low-productivity workers with and without jobs.[5] Such a safety net is clearly more equitable than a minimum wage, that confers relatively small advantages on the majority of low-productivity workers fortunate enough to hold on to their jobs, but it damages the minority who are precluded from jobs, possibly severely in some cases. Moreover, the establishment of a minimum wage at a level in excess of the community wage would deny some people the opportunity to earn an income that is higher than they would obtain without a job.

If the earnings of the minority of low-productivity workers whose wages remain persistently low are judged to be inadequate, other forms of income support, such as the guaranteed minimum family income or low-income earner tax rebates, should be re-examined. The advantages of these measures, relative to minimum wages, are that they can be targeted on those whose earnings can be expected to be persistently low and that they do not unduly preclude access to the labour market.

There are two common but unconvincing objections to shifting the emphasis from minimum wages to transfer payments. The first is that in the absence of minimum wages, employers are claimed to be able to 'exploit' low-productivity workers. However, as pointed out above, no employee will knowingly accept an employment contract which makes them worse off than on the community wage. The worker with alternative job opportunities is a very difficult worker to exploit. As Alchian and Allen (1983) observed in relation to collective bargaining:

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

The best form of 'worker protection' is a well-functioning competitive labour market with high levels of employment. Minimum wages are an obstacle to full employment. Moreover, the presumption that 'exploitation' allows higher profits rests on limits to competition for workers. If workers are mobile, competition at the margin is not limited. The possible damage to employees from 'exploitation' in the absence of a minimum wage should be compared with the damage to those precluded from employment by a minimum wage.

A second objection is that the effect of income support is to deliver a subsidy to employers. Income support payments can be expected to shift the labour supply curve of low-productivity labour to the right, thereby tending to lower wage rates for low-productivity labour. The benefits of this shift will be shared between employees and consumers depending partly on elasticities of demand and supply. They cannot go to employers who (in competitive labour and product markets) will only be able to earn a normal rate-of-return. It is worth noting in this context that some economists regard employment subsidies as an important instrument for ameliorating unemployment (see, for example, Phelps, 1997; Organisation for Economic Cooperation and Development (OECD), 1997). This view is contingent on the absence of superior instruments (eg the removal of labour market rigidities) for promoting employment. The use of income support measures as proposed does not depend on a 'second-best' justification of this kind and, given that it

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5 This does not imply that incomes will be equalised, the (presumed) higher incomes of those with jobs reflecting the disutility of working and loss of leisure time.

will expand output and hence employment and does not add to employers' returns, it is hard to see valid objections to it.

Income support programmes such as the guaranteed minimum family income and the former training allowance have not attracted criticism on the grounds that they constitute an employment subsidy. Schemes such as the guaranteed minimum family income are targeted to low-income families with dependents and the family status of a worker is not normally a factor for an employer in determining wage rates.

In summary, a statutory minimum wage cannot be targeted closely on people who are likely to face continuing financial hardship and the burden of these transfers is not shared equitably over the population. For these reasons, we consider that it is not an appropriate instrument for underwriting income levels in accordance with the objectives of producing a more desirable distribution of income and wealth and a fairer society. Income support measures are likely to be superior instruments for raising the earnings of low-wage employees because they can be targeted on genuinely disadvantaged employees, the cost is shared more equitably across households, and the labour market is left to do its prime job of matching the supply of and demand for labour.

III CONCLUSIONS AND RECOMMENDATIONS

We oppose increasing minimum wages mainly because there are convincing reasons for expecting that at least some people, conceivably numbering in the thousands, will be precluded from jobs. Because they tend to be the least profitable to employ, people whose productivity is low (either because they lack education and training or have low innate abilities) are those most likely to be precluded from employment. The combined effects of loss of income, loss of training opportunities, loss of reputation, and loss of self-esteem may have serious consequences for already disadvantaged people over their entire working lives. These effects may extend to other members of their households.

Undoubtedly a number of people would gain from higher minimum wages. However, in our opinion, the social benefits of these higher wages would be outweighed by the adverse consequences for those precluded from jobs. Factors that have been taken into account in making this judgment are that the benefits of minimum wages are poorly targeted on financially stressed households; the resultant redistribution of income may in some cases not be consistent with generally accepted notions of fairness; and that there are superior policy instruments for improving the welfare of low-wage employees.

If the incomes of low-wage employees are judged to be inadequate, the appropriate remedy is to provide some form of income transfer, that does not create an undue obstacle to welfare-enhancing employment contracts through the labour market.

The negative effects of higher minimum wages on employment would almost certainly be more severe if demand for labour is weakened by the effect of the current global instability on aggregate demand in New Zealand. Consequently this is an especially inauspicious time to raise minimum wages.

Finally, whether or not minimum wages are raised, in our view provision should be made to allow people to opt out of the provisions of the legislation in certain circumstances. Those would include people in jobs that contain a training component, new entrants to the labour market and people unemployed continuously for more than six months.

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ASSOCIATION OF BULK FUNDED SCHOOLS

RESTORING SANITY TO EDUCATION

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

TAUPO
24 SEPTEMBER 1998

RESTORING SANITY TO EDUCATION

The urgent task in education is to restore its sanity. I don't mean to imply that teachers have taken leave of their collective senses. Far from it. Given the policy environment in which they perform their task, it is very much to their credit that they haven't. In fact what sanity remains in education is very largely to be found in the individual schools, classrooms and homes of New Zealand.

The main source of many of the aberrations within education is the official education establishment. That schooling retains its vitality is largely due to the resistance of individual teachers to the contagion from Wellington. Your auto-immune system is still intact, but nonetheless it is my contention that this influence is widespread and having profound and deleterious effects on schooling in New Zealand. Let me use the examples of reading and grammar.

We now have more than a generation of New Zealanders who were mostly denied any instruction when taught to read about the relationship between letters and their sounds – that is, phonics. Indeed phonics has long been a dirty word among New Zealand education officials and teacher education circles, though no doubt phonemic awareness has been taught surreptitiously in at least some of our primary – and perhaps secondary – classrooms. It has also been sustained by doughty campaigners like Doris Ferry with encouragement from courageous academics like Tom Nicholson, Bill Tunmer and Brian Thompson.

Perhaps phonics enthusiasts are beginning to come 'out of the closet'. It was certainly good to read about Don Buck Primary School in Palmerston North "going out on a limb against the official line of thought" to introduce a phonics-based programme from which "phenomenal" results were reported.[1] It is amazing to me that anyone should want to deny children one of the advantages of English which is that it is a phonetic language. Yet the so-called 'whole language' approach infects many parts of the English-speaking world. It seems to be on the wane, except in New Zealand that is still regarded internationally as "a centre for the whole language approach".[2]

A recent report in *Forbes* magazine called the whole language method of teaching children to read "one of the goofiest, most destructive educational fads of recent times". It commented that "It's astonishing that what is essentially a system of guessing words could become so widespread in [American] schools, underscoring how frivolous many educational bureaucrats have become". I am not sure that "frivolous" is the word I would use, but I share the sense of amazement at the inanities of our educational bureaucrats. The article noted that California had tried this "bizarre approach" for nearly a decade, but when reading scores plunged to be the worst in the United States the Californian legislature decisively abandoned it.

In Britain too, the secretary for education in the Labour government, concerned about literacy standards, has published a framework which ensures that children learn phonics in the early years, as well as receiving clear instruction in grammar.[3] I know of no such recantations and injunctions from our Ministry of Education.

In New Zealand, grammar too has been a casualty of the Ministry of Education. You will find minimal reference to grammar in the new English curriculum for our schools,

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1 Carrol, P (1997), 'Phonic approach to reading brings "phenomenal" results', *New Zealand Herald*, 20 December.

2 Nicholson, T (1996), *Historical and Current Perspectives on Reading*, paper presented to symposium on "Integrated direct instruction – balancing phonics and whole language", Oklahoma City, February.

3 Letter to the editor from David Blunkett, *The Spectator*, 25 April, 1998.

notwithstanding earlier ministry assurances that the final document would "more heavily stress" the basics of reading, writing and grammar after expressions of concern at their neglect in the draft curriculum.[4] The final document simply continued the trend away from formal instruction in the structure of language. It says "students should explore and develop an understanding of grammar". Once upon a time we had to learn and practice grammar and be drilled in it.

It is little wonder that academics in several disciplines and many employers have long been complaining that apparently well-educated young people arrive at their doors unable to put a decent sentence together. Recent surveys have confirmed what has been suspected. The International Association for the Evaluation of Educational Achievement (IEA) study of reading literacy showed up a long tail of low achievers in reading among children.[5] A recent study of adult literacy showed that nearly half of those aged between 16 and 65 had either very poor literary skills or could only use relatively simple printed material.[6] I am not surprised but I am, nonetheless, appalled.

I do not for a moment pretend to be an expert in these subjects. Nor do I assume that phonics is the exclusive answer to learning to read. Those whose judgment I respect say that, when teaching someone to read, a range of methods and approaches is required, combined with professional judgment about when and how a particular method or combination of methods should be employed. But I am in no doubt that official policy is wrong and has been seriously wrong for a very long time. The neglect of phonics and grammar is important not only because they are fundamental to just about everything else in schooling but also because their neglect raises serious questions such as how is it that New Zealand so readily adopts overseas fads to the obvious detriment of our children. And again, how it is that we can hang on to such international fashions well after they have been abandoned or are in the process of being dismantled elsewhere?

I suspect there are several answers. First, we lack rigorous, critical, sceptical, probing educational debate in New Zealand. The Ministry eschews serious debate and puts up prepackaged answers in the form of Green Papers or so-called discussion documents. It makes little attempt to provide intellectual leadership on educational matters or even to explain its stance on particular issues. In short, it can get away with lack of intellectual rigour and with policy ineptitude and has been so doing for years.

The second point, however, is that this situation persists because we have a small educational community that is homogeneous in outlook and spends much of its time in mutual adulation. Read the articles in some of New Zealand's educational journals and you will see what I mean. It is only when organisations like the Association of Bulk Funded Schools or the Education Forum speak out that any debate of significance ensues and, in my experience, the Ministry then seeks to defuse it as quickly as possible, usually by ignoring any serious criticism of its proposals. Education academics and teacher unions tend to avoid serious debate by resorting to name-calling and putting those who think differently in 'boxes' to which they then attach pejorative labels – I suspect the Association of Bulk Funded Schools knows all about such tactics.

But this uniformity of outlook involves an educational credo that needs to be examined. There seems to me to be a cluster of related ideas that explain the present deeply worrying situation.

First there is, I suggest, profound and debilitating confusion within the ministry and the academic world about the purpose of schooling. The liberal view of the purpose of

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4 Catherall, S (1994), 'Grammar Added to English Syllabus', *The Dominion*, 14 December.

5 Wagemaker, H (ed) (1993), *Achievement in Reading Literacy*, Ministry of Education, Wellington.

6 Benseman, J (1997), 'Illiteracy among adults a real and extensive issue', *New Zealand Herald*, 2 December; Ministry of Education (undated but presumably 1997), *Adult Literacy in New Zealand – Results from the International Adult Literacy Survey*, Ministry of Education, Wellington.

education contained several important notions. It assumed, for example, that education had its own intrinsic merits and required no justification external to itself. Implicit in this was the understanding that some works are of great merit and enduring value and the young needed to be exposed to them. Great literature was deemed great because it opened up the range of human possibilities and wrestled with enduring aspects of the human condition and the meaning and purpose of life. Science was seen as a process for discovering more about the physical world with the young 'standing on the shoulders of the giants that had gone before' to understand what they had seen and, if possible, to see a little further. Education was perceived as the means of transmitting knowledge and the best of the national culture so that the young can grow up with some familiarity with the world about them and move within it with confidence.

What we find in official documents about education is totally different, and there can be no illusions about the sea change that has taken place. We find crass references to education serving external ends incorporated in "national aims" and "strategic directions" along with educational gobbledygook like "a seamless education system".[7] Education is increasingly seen as serving economic ends. Thus in the foreword to the curriculum framework we find a reference to "today's and tomorrow's competitive economy" and the "need [for] a workforce which is increasingly highly skilled and adaptable …".[8] The sheer banality of it all is amazing, especially in such an important national document, and it hasn't come from the business community but from barbarians within the educational gates. Of course, education has important implications for the economy and the workforce but it is the reductionism – the idea that the purpose of education can be reduced substantially to workplace preparation – that is deeply disturbing.

Education has become utilitarian in another important but perhaps even more disturbing way. It is seen as a means of reconstructing society. And the manner in which it is to be reconstructed is determined for us by education officials and their fellow-travellers in the education faculties and colleges. These socio-critical theorists seek to force on children *via* the school curricula particular views about New Zealand as a bicultural society, about the Treaty of Waitangi, and about gender and race and to recreate our society according to their own prescription. They wish to force on New Zealand children their disdain for western culture and its intellectual achievements. The boundaries between indoctrination and education have indeed become blurred, and this is, in my view, a major catastrophe for New Zealand – far worse than any buffeting on the international financial markets.

Another major trend is the shift in emphasis and focus away from what is taught – the content of education – and from the teacher to the pupil. The pupil is now seen as the centre of the intellectual universe, unencumbered by existing authorities, institutions and structures, and certainly not constrained or instructed by the teacher. Children are understood to enter school with all the inner resources required for education, including moral education, awaiting only suitable opportunities and perhaps the facilitation of a teacher for release.

The child's self-perception is everything. Nothing must damage the apparently fragile self-esteem of our children. In the most amazing drivel I have encountered for a long time, the draft Health and Physical Education curriculum statement contains copious references to the "personal identity" and the "self-worth" of the student. These are said to be inclusive of alternative terms such as "self-esteem, "self-confidence" and "self-concept". The over-riding concept is that of "total well-being". No standard is suggested against which the worth of self might be assessed. The draft curriculum does, however, open with the statement that "Positive feelings in your heart will raise your sense of self-worth",[9] that at least warns the reader of the inanities to follow. The curriculum claims to identify the

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7 Smith, L (1994), *Education for the 21st Century*, Ministry of Education, Wellington.

8 Ministry of Education (1993), *The New Zealand Curriculum Framework*, Learning Media, Wellington.

9 This is a translation of a Maori saying which in its own context may make good sense.

knowledge, understandings and skills necessary to assist the development of total well-being – and not just for the students but for their communities and society as well! The message of the draft curriculum seems to be that if you follow it faithfully nirvana will be achieved for all. Much of it is psychobabble and new-ageism.

This notion of child-centred learning explains, I suggest, the aversion to phonics. The 'look-say' method, as British philosopher Roger Scruton has pointed out, makes the child and not the text the principal authority as to what is happening on the page.[10] Phonics requires learning rules, and of course their exceptions, and drill; and such, it seems, are anathema to our educational bureaucrats. The same can be said of science which hitherto has required much knowledge and conformity to the rules of science when testing hypotheses about the physical world. But now, according to our new science curriculum, science is "an activity that is carried out by all people as part of their everyday life", and scientific learning is enhanced when "all the experiences, ideas, and beliefs, which students bring into the learning situation are acknowledged as a basis for learning".[11] This is hogwash. Simply watching flowers unfold or the effects of yeast on flour and water is not doing or learning science. And many of our notions about the world are not scientific and form no basis whatsoever for scientific learning. Learning science involves acquiring a great deal of knowledge, and doing science involves familiarity with scientific method. But in the new-age view the child's self-esteem is of primary importance and truth – if it exists at all as a useful concept in the mind of ministry – is secondary.

Our current obsession with 'skills' is also part of officialdom's aversion to any 'givens' in education, that is, to knowledge that has to be learnt and acquired with hard work and concentration and not simply invented by the child as and when he or she sees fit. Until quite recent times, education was concerned principally with knowledge – with things like the structure and grammar of the English language, with literature, with French irregular verbs, with names and locations of cities, rivers and mountains and with the dates of kings, queens and emperors. Such knowledge was considered important because it was part of our cultural inheritance and worth knowing for its own sake. This emphasis on knowledge did not assume that 'skills' were unimportant. Rather it was understood that the engagement with knowledge would necessarily develop skills. The point was, as Professor Kenneth Minogue has observed, "to leave pupils alone to their own thoughts and inclinations. Education was not a production line attempting to turn out creatures with fixed and determinate ideas".[12]

'Skills' are now seen as separate to knowledge or content and to be considered separately. But quite how skills are to be acquired except in engagement with content is a puzzle. The mystery deepens with the ministry's latest Green Paper on assessment at the primary school level that refers explicitly to "the shift from a content-based curriculum to an outcomes-based curriculum".[13] At first glance this may seem to be very appealing – after all, we are concerned that education has some results or 'outcomes'. But the Paper seems to be saying that now we have a content-less curriculum. Professor Cedric Hall has generously suggested that this extraordinary statement might be dismissed as a "bad day for the writer – he or she didn't quite mean what was written".[14] But frankly I am not sure. Most of the 'outcomes' in the curricula documents and the 'elements' in the unit standards

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10 Scruton, R (1997), Foreword to Partington, G, *Teacher Education and Training in New Zealand*, Education Forum, Auckland, November, p xiii.

11 Ministry of Education (1993), *Science in the New Zealand Curriculum*, Learning Media, Wellington, pp 9 and 10.

12 Minogue, K (1996), Foreword to Education Forum, *Social Studies in the New Zealand Curriculum – A submission on the Revised Draft*, Education Forum, Auckland, October, p ix.

13 Creech, W and Donnelly, B (1998), *Assessment for Success in Primary Schools*, Ministry of Education, Wellington.

14 Hall, C (1998), Student-Centred Learning: A World Class Focus, Inaugural Address, Victoria University of Wellington, 25 August.

are in fact very vague and open to wide interpretation; most are certainly not specified in traditional content form.

Professor Minogue, in comments on the revised draft of the Social Studies curriculum, views the "skills philosophy [as] an attempt to invade the child's mind and to dominate it. It sought nothing less than to get inside his or her experience and take it over". He observed that:

> This new philosophy could not even leave 'creativity' alone. That, too, was to be taught in schools, just as the [revised Social Studies draft] wants children to "try out innovative and original ideas". It seems that originality grows on trees. It would be nice to see just a little bit of it in this draft.[15]

Of course, the openness of the curriculum merely invites those with views about the way in which society should function to use the curriculum to advance their own ideas. Our progressive educational officials and their academic fellow-travellers are not slow to use the opportunity and in doing so are, in fact, denying children the opportunity to exercise 'critical thinking' which is one of the skills promoted in the new curricula. Pupils are, it seems, only to think critically according to the norms that have been critically defined for them by our socio-critical theorists.

Biculturalism and partnership are two particularly prominent concepts in education yet neither have been defined or defended – simply asserted and thus left wide open to interpretation.[16] Educationalists who promote these concepts as central to their educational concerns and institutional missions have been challenged to explain how, for example, the Treaty established two partners, in what way can Maori and non-Maori be seen as two collectivities, how can such groupings be 'partners', and in what common enterprise are they engaged.[17] No answers have been forthcoming. I note that the Social Studies curriculum does not define a Maori so presumably allows the definition to be self-chosen, but it does define a Pakeha as "[a] New Zealand-born person of European descent who chooses to be called Pakeha to describe their ethnicity". This disenfranchises all New Zealanders who are not of European or Maori descent, those of European descent who were born outside the country, and those who would otherwise qualify but who do not wish to define their ethnicity as 'Pakeha'.[18] This is just one illustration of the conceptual nonsenses – and excruciating grammar – perpetrated on New Zealanders by the politically correct establishment in Wellington.

Morality is now also an open question and again our education bureaucrats are keen to fill the vacuum. Following an international fashion, now in decline elsewhere, morality has been stripped of any objectivity and we now only have 'values' education, the sole purposes of which are to help children explore and clarify their own values and to learn to tolerate those of others. The traditional notion that some things are simply *wrong*, and that children have to be corrected and habituated into correct attitudes and behaviours, is quite foreign to the draft Health and Physical Education curriculum statement. Indeed one of the two principal writers of the draft stated that its developers attempted to "avoid the '*moral fascism*' associated with the development of appropriate *attitudes* in students (emphases in original)".[19] I wonder how those who have endured the cruelties of actual fascism react to this unmaking of language. In any case, it is difficult to imagine a more

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15 Minogue, *loc cit*.

16 Fancy, H (1997), *Social Studies in the New Zealand Curriculum*, Ministry of Education, Wellington, states at page 21 "Students of social studies will understand the nature of biculturalism and the partnership between Maori and Pakeha".

17 Irwin, M D R (1997), *Follies and Fashions in New Zealand Education*, paper presented to the Waikato Forum on Education, University of Waikato, 7 August.

18 Fancy, H (1997), *op cit*, p 57.

19 Culpan, I (1996/97), 'Physical Education: Liberate it or Confine it to the Gymnasium', *Delta*, 48 (2), 49 (1), p 217.

individual approach to the business of how we should live together. Yet the other principal writer, in defending the draft, asks whether the final statement will be "a step backwards to the individualism of the past?"[20] How could such a child-centred, needs-based and values-based curriculum be considered other than highly individual? How could it possibly be still more individual without abolishing teachers and schools as potentially, if not actually, corrosive of the autonomy of the individual child?

This is not too outrageous a question. While I have seen no suggestion that schools should be abolished, except by over-enthusiastic promoters of the electronic classroom, the role of teachers is certainly in doubt if they are reduced to being mere facilitators. If content is belittled, if children decide their own needs, their own values, and their own rate of progress, if knowledge cannot be transmitted as some of our influential constructivists maintain, and if meaning is entirely individual as the deconstructionists would have us believe, then what need is there for teachers in the traditional sense of those who instruct on the basis of superior, substantive knowledge? In fact, the Ministry has recently, in its Green Paper on teacher education, endorsed the view of teachers who see "themselves *not as 'teachers'* but as facilitators for children" (emphasis added).[21] This view seems to be driven by an over-inflated estimation of the contributions of information technology and an aversion to 'static' skills and knowledge. 'Flexibility' seems to be the key Ministry concept.

However, the mention of 'flexibility' gives the Ministry game away. The Ministry has slipped, perhaps unconsciously, into postmodernism – that bunch of ideas and notions the common themes of which are that nothing is fixed, nothing is static, the individual is all-important, and flexibility is everything. What is right and good for me is fine, even if it is anathema to you. There is no Truth, only individual truths. There is nothing intrinsically worth passing on to the next generation because we all have individual and differing views about the worth of everything. There can be no analysis and debate with an aim of coming to a common view on issues, only discourses to clarify our own individual perspectives.

All this is deeply disturbing. What should be done about it? Part of the answer is to identify what is going on and to speak out about it. We must go on doing this and I look forward to the day when teachers will have their own independent professional body to research, inform and make representations on educational issues. But I do not think that speaking out is enough. There will always be dangers with heavy government involvement in schooling, especially over the curriculum and teacher training. It is folly just to wait for the 'right' team in government to take charge. Perhaps they will one day but, sooner or later, the 'wrong' team will take over from the 'right' team. As long as control remains highly centralised, the curriculum is always going to be a battleground for warring factions.

The problem of heavy government direction in education is not confined to the curriculum and pedagogy. The Education Forum has published reviews or made submissions on all the main curriculum, qualifications, teacher education and assessment proposals of recent years. Many of the authors of the reports and those who have assisted the Forum in the preparation of submissions are highly distinguished academics. Their views of the Ministry's proposals and decisions in these areas have ranged from disappointment to total rejection. The contention that there is something very seriously wrong with the ministry's performance in these areas cannot be attributed to the idiosyncratic views of one or two cranks from some extreme point on the ideological spectrum.

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20 Tasker, G (1996/97), 'For whose Benefit? The Politics of Developing a Health Education Curriculum', *Delta*, 48 (2), 49 (1), p 199.

21 The Green Paper (*Quality Teachers for Quality Learning – A Review of Teacher Education*, Creech, W, Ministry of Education, 1997) endorsed the findings of Ramsay, P and Oliver, D (1995) 'Capacities and Behaviours of Quality Classroom Teachers', *School Effectiveness and School Improvement*, Vol 6, No 4.

The National Qualifications Framework is just as much an educational disaster as the New Zealand Curriculum Framework and its constituent curriculum statements. Both are ill-thought out 'think-big' disasters enthusiastically promoted by a previous minister of education, Lockwood Smith. I would like to think that we have passed the hubris that also led to Dr Smith's *Education for the 21st Century* with its 'command economy', quantitative approach to educational planning.[22] Thankfully that document has been forgotten, but I am not sure that we are any further ahead. The qualifications framework has been under review for some time but the relevant Green Paper on it was of very poor quality and more than a year after submissions were made we have still not seen the outcome.[23] The Ministry continues to introduce its curriculum framework in spite of the most serious criticisms of it and its component statements. This hardly indicates that the lessons from recent failures of 'think-big' disasters have been learnt.

The problems with these nation-wide arrangements are essentially twofold. First, if they are wrong they affect everyone, and because there are no alternative systems in place their weaknesses may not quickly come to light. Moreover, those responsible for developing and implementing the systems acquire a personal stake in them and resist criticism and change. The other main weakness is that they impose one solution to a variety of problems. We have, for example, no significant curricular or institutional differentiation at the school level. This contrasts with countries in continental Europe that generally have both. We can, and in my view should, debate these issues, but the point is that diversity and experimentation to meet the widely varying abilities and aspirations of our children are effectively precluded by the present 'one-size-fits-all' approach.

The only long-term, effective solution is to remove substantial parts of schooling policy from the centre in Wellington and give back control to the teaching professionals in schools and to parents. My prescription would have the following key components. First, the state-mandated curriculum would be severely limited to a group of core subjects, including the international 'languages' of English and maths. At the primary level the mandated curriculum might cover two-thirds of the total curriculum and reduce to, say, half at the junior secondary level. From then on a variety of programmes, reflecting the diverse interests, abilities and aspirations of our young people, would lead to a range of reputable qualifications offered by independent examining bodies.

Secondly, the state's involvement in national assessment would be limited to testing all children at, say, age 10 to see whether they have acquired the expected levels of numeracy and literacy. The tests would be externally set, administered in schools according to a set timetable, and externally marked. The national and school results, in the form of the percentages of children achieving the desired levels, would be published. The aim would not be to assess schools but to put in place clear expectations, incentives and, where necessary, additional resources to ensure that all children, apart from those relatively few with significant disabilities, achieve the foundations on which all further education must be built. Other tests would be available but optional. This is in essence what the Education Forum has recommended in its submission on the Green Paper on national assessment.[24]

Thirdly, all schools, both private and government, would be funded on the same basis. There is absolutely no rationale for the present distinction in funding levels between

22 Smith, L (1994), *Education for the 21st Century*, Learning Media, Wellington. Another of Lockwood Smith's initiatives – the Parents as First Teachers Scheme – has also recently been criticised – see Boland, M J (1998), 'Parent Help Scheme "Flops" ', *Weekend Herald*, 22–23 August.

23 Creech, W (1997), *A Future Qualifications Policy for New Zealand: A Plan for the National Qualifications Framework*, Ministry of Education, Wellington, May.

24 Education Forum (1998), *Policy Directions for Assessment at the Primary School Level – A Submission on the Government Green Paper 'Assessment for Success in Primary Schools'*, Education Forum, Auckland, August.

schools on the basis of ownership except, of course, to protect government schools from competition. In effect what I am advocating is that the bulk-funding formula would be extended to all schools and not just to the courageous minority of government schools that refuse to be bullied by the teacher unions. Integrated schools should be allowed to revert to private status if they wished to do so.

Fourthly, if government schools are to prosper in this more open, vigorous climate, some of their present shackles must be removed. Principals must be allowed freedom to enter into contracts with their staff, unconstrained by national awards. Schools need the flexibility to enable them to design programmes according to their own assessment of what is appropriate to the children they seek to serve. Governance arrangements need review: if parents had a more effective choice of school there would be far less need for them to be represented on governing boards. The issue of ownership of government schools would also arise and alternative forms, perhaps local educational trusts, could be considered.

If we were to introduce such reforms I think we would go far to contain the contagion from Wellington to which I referred at the outset. We cannot eliminate it and fresh outbreaks are always possible, but at least we would have put in place a means of identifying this influence and containing it. At the end of the day it is a question of whether we want all important schooling decisions to be made for us by educational bureaucrats and their academic colleagues or by teachers and their principals working in collaboration with parents. I suggest the choice is not a difficult one.

NEW ZEALAND ASSOCIATION OF PRIVATE EDUCATION PROVIDERS

A BUSINESS PERSPECTIVE ON THE PRIVATE TERTIARY EDUCATION SECTOR

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A BUSINESS PERSPECTIVE ON THE PRIVATE TERTIARY EDUCATION SECTOR

Introduction

It is a genuine pleasure to be invited to speak at this conference. The New Zealand Business Roundtable has been arguing the case for improving the policy framework for all tertiary providers since the late 1980s. Some progress has been made and it is impressive to see that the private tertiary sector is developing into a thriving industry. I would like to think that we have helped to make this possible, but you must be congratulated on doing the hard work.

It appears that the Business Roundtable and the New Zealand Association of Private Education Providers share many core beliefs. We both believe that quality education is crucial for New Zealand's future. We both believe that education should be delivered by the provider that best meets the needs of the students concerned. Both our organisations have supported greater competition in the tertiary education sector and argued that funding should follow the student. Speaking to a group that shares so many beliefs is a pleasant experience, and I look forward to discussing some ideas with you this morning.

The main issues for this session are the expectations that businesses have for tertiary education and the role that private training establishments (PTEs) have to play in that sector. The role of the government in developing a regulatory framework for education services is relevant to both of those issues.

The expectations of business

The Business Roundtable is an organisation of 50–60 chief executives of some of New Zealand's largest businesses. Our aim is to support policies that advance the interests of the wider community rather than sectional interests. That may be another belief that our organisations share.

The business community takes a keen interest in education not just because of the long-term effect it has upon business competitiveness but because of its wider benefits for society. Human capital – the knowledge and skills embodied in people, their health and the quality of their work habits – accounts for a large and probably growing proportion of gross domestic product (GDP).

An individual's potential human capital is due to innate ability, but the way in which that potential is developed is strongly affected by the performance of our formal and informal education systems. The expectations of business are that those systems will encourage optimal investment in human capital in New Zealand and thereby promote a more prosperous economy and advance other social and cultural goals.

The informal education system, operating through on-job training and personal development, may account for a larger portion of educational expenditure, in time and money, than the formal education system. Studies have found that informal education and training contribute more than formal education to people's incomes. This suggests that investment in informal education may be larger than in formal education. The formal education system, including PTEs and tertiary education institutions (TEIs), is, however, where most of the policy debate is focused. I will concentrate on that area today, but businesses and individuals will weigh up formal and informal educational options when they make their own investments.

One of the key themes of vested interests in the tertiary education sector is that education is special and should be treated in a different way from other sectors. In his 1995 Sir

Ronald Trotter Lecture, Richard Epstein of the University of Chicago Law School commented on that contention as follows:

> Whenever somebody tells you that something is special, remember that the history of government failure is littered with arguments that this, that or the other thing is special. We had labour unions in the industrial sector because it was special; we had Medicare in health because it was special; we had subsidised public housing because housing was special; we had price controls in agriculture because it was said to be special. It turns out that there is nothing special about anything. A few central principles consistently applied will tell you the appropriate scope for individual choice on the one hand and for government action on the other. Education is not a case of overgrazing of a common. It is not a case of negative externalities from pollution. … Education is the stuff of ordinary transactions, which should be as routine as we could possibly make them if only we had the wit to allow our imaginations to run wild with our schooling instead of with engineering our social arrangements.

While tertiary education is not special compared with most other industries, investment in it entails an important decision for individuals and businesses. That should lead to considered decisions as to the nature, length and level of tertiary education students undertake. Businesses should also make careful decisions about the skills they require from employees and send the appropriate signals through their recruitment, development and remuneration policies. These decisions are likely to have the lowest risk and greatest return for individuals, businesses and society when they are made in a stable environment with a minimum of government intervention.

The Business Roundtable's submission to the Tertiary Education Review argued that the policies required to encourage appropriate investment in tertiary education include:

- a stable macroeconomic environment that fosters certainty and facilitates investment, including long-term investment;
- an efficient labour market that provides strong incentives for people to develop desirable work habits and to acquire education and training;
- an open immigration policy that facilitates the introduction of new skills and promotes innovation;
- a low level of government expenditure and taxes, the avoidance of excessive regulation and a carefully designed welfare system. These are necessary to limit perverse incentives that impair work habits and discourage investment in human capital;
- a reduction in the level of subsidies for tertiary education and a review of the type of activities that are assisted so that any subsidies that are provided are justified on valid public policy grounds. This would eliminate the bias toward off-job education and training, improve the effectiveness of spending on formal education and training and reduce the tax burden;
- a reduction in barriers to entry into, and exit from, the education industry that would improve the efficiency of the provision of education;
- the adoption of private ownership arrangements; and
- the removal of preferential treatment for any state entities that are retained and the introduction of governance arrangements that would facilitate more effective decision-making and improve their performance substantially.

Unfortunately, New Zealand governments have treated tertiary education in a 'special' way. They have 'planned' the number of graduates needed in particular areas, for instance in many health professions. You will be well aware of the list of priority courses that the Ministry of Education has hitherto used to ration funding to the PTE sector. It may be cold comfort for those whose courses were not prioritised that the Ministry's own advice to its minister was that:

> The priorities were not based on any analysis of supply and demand or occupational forecasting.

It is unclear which is worse – that officials did not carry out such a wasteful analysis or that they carried on with the policy without any empirical backing at all! It seems that the Ministry of Education stopped using all the tools of central planning but could not quite break the habit.

The government has also limited the choices available to students by imposing high entry barriers. Any tertiary institution can now offer a degree as long as it meets the NZQA's complex and arbitrary standards, and ensures that its teachers are engaged in research. There is no good reason for all degree courses to be taught by researchers just as there are no good reasons for clothes to be sold by designers. You may order a made-to-measure garment from the designer but you can still purchase a perfectly serviceable coat from the retailer. The choice should be up to the consumer.

The consequence of excessive government intervention in the economy is low consumer satisfaction. Today, education and health – rather than the telephone system – stand out as major areas of community dissatisfaction in surveys of public opinion.

The tertiary education industry's performance

So how does the government affect the education industry? The government has three main roles in the education market at present. It provides the largest share of funding of students' education and favours those studying at its own institutions. It owns institutions that have a very large market share, while requiring no return on the equity invested in them. It also regulates the sector by creating high entry and exit barriers, thereby limiting competition and reducing diversity in the market. This creates poor incentives for managers and academics to perform and low levels of responsiveness, innovation, productivity and consumer information.

Students and businesses expect high levels of responsiveness to their needs from education providers just as they do of doctors, dairies and entertainers. Many TEIs have been unresponsive to changing needs, often placing students in queues for course places or taking two or more years to develop a new course. They are frequently distant from business needs.

Private providers who are always looking for new profit opportunities or new ways to serve a particular community are more likely to meet any interest, and minority interests in particular. This can be seen in the development of PTEs and semi-private TEIs such as wananga that meet the needs of Maori, Pacific Islands people as well as emerging business needs – such as in the design or early childhood education areas. Indeed, PTEs appear to enrol a higher proportion of people from lower socio-economic backgrounds than do TEIs, turning the myth of elitist private institutions on its head. Private providers are looking for a market while a problem with public providers is that they are directed by political parties aiming for the swinging voter.

A second problem in the tertiary education market is low productivity. Any institution that is protected will argue that it is operating at maximum productivity. Its achievement is usually credited to its level of protection – as manufacturing industries argued in the past. In opposing the reforms of the late 1980s, the university sector strenuously maintained that it was operating at the frontiers of international excellence. Given that starting point, it is remarkable that the universities have greatly improved their human resources, marketing, property and financial management performance over the last 10 years. They have also increased the attention they pay to student satisfaction with academic and non-academic services. But as anyone with any acquaintance with universities knows, there is enormous scope to do better. The PTE sector has achieved still higher usage of facilities through longer teaching days and years, it has improved its marketing techniques, built better linkages with employers and reduced administrative overheads.

A lack of innovation is a third problem with our current tertiary system. Innovation is not a characteristic of centrally administered organisations. Prior to 1990, polytechnic courses had to be approved by the Department of Education. Now polytechnics and other TEIs are free to offer whatever courses they wish, providing they can secure approval, funding and students. However, they are still slow to exploit new delivery methods. This is not the fault of the people employed in these institutions. Since they have limited freedom in staffing, governance structures, management and finances, they simply don't have all the tools necessary for innovation. PTEs, on the other hand, can develop a more entrepreneurial culture and respond to incentives to innovate. They can change their mix of resources, implement new ideas and think the unthinkable. Accordingly, they have consistently led the field in offering shorter courses or more student contact time in order to meet consumer needs.

Information is a fourth problem area – an area that is crucial to effective human capital investments. Like all investments, those in human capital are risky and people seek information to reduce the risk involved. However, when students pay a relatively low proportion of the costs of tertiary education, they will spend less time and money making informed decisions. TEIs receive most of their funding from the government and they face limited competition for students. This means they have poor incentives to supply better information. In contrast, PTEs face tougher competition, source more of their revenues from students and thus have to do more work convincing students to enrol. Accordingly they generally produce better quality information about their offerings and returns on them, including graduate employment rates.

The main problem with the public provision of services is that the incentives facing public providers are relatively weak, whether services are judged on price, quality, availability or other factors. Public managers' rewards may come from the size of their budget or staff numbers rather than the satisfaction of their customers. Political considerations, rather than demand, may drive decisions about supply, resulting in rationing, unsatisfactory products or no products at all. Managers may also have limited freedom of action in deploying human, financial or physical resources.

Such insights may seem obvious to anyone who has been exposed to the Inland Revenue Department's (IRD's) telephone system, but they have seldom been applied in New Zealand tertiary education. As the Department of Education put it in 1987, in an analysis of the role of the private tertiary education sector:

> The existence of the private market serves as a reminder to the government funded formal sector of the need for effective delivery and consumer satisfaction.

We should commend education officials for recognising that the private sector delivers effective services that satisfy consumer needs. It is difficult to understand, though, why the government didn't shift the funding from the sector that needed to be reminded about such fundamentals to the one that was already highly conscious of them. It says something about the diffusion of ideas in the public sector that it took the government until 1998 to follow the argument through.

Private provision of tertiary education

A slow pace of reform is a familiar story around the world in the provision of social services, which are often the last industries to be reformed. The World Bank has found that there are usually three waves of privatisation in an economy. The first concerns organisations that already operate in a commercial environment, such as airlines. The second deals with infrastructure such as gas and electricity operations while the third wave relates to social services, such as health and education. We are just starting on that third wave in New Zealand and it may be the most important for our long-term prosperity.

The public policy basis for private provision of tertiary education services is quite clear-cut, given the inevitably weak incentives facing public providers. Even the major TEI associations now support the public funding of PTEs, as long as they meet "certain conditions". The issue is now clearly in the political arena and the aim must be to demonstrate the benefits of private tertiary education to politicians and the public.

We are not starting from a blank slate with private tertiary education. There are 800 registered PTEs in New Zealand, and many thousands of unregistered computer applications trainers, driving schools, speech therapists, time management and planning consultants, dance teachers and the like. Besides those stand-alone operations there are thousands of people employed in human resource units in firms and many more managers who coach and develop their staff. Everyone in this country has some experience of private education.

There are thriving private sectors in other countries. In Australia, the private tertiary education sector is at a similar stage to that in New Zealand, although there are private universities. In the United States, there are private institutions at all levels, from small proprietary institutions to major universities such as Yale and Harvard. In Japan, most of the tertiary education sector is privately owned and there is a flourishing for-profit tertiary education sector in the Philippines and in Chile.

There are some interesting for-profit institutions in the United States as well. The De Vry group of companies offers short vocational courses as well as degrees in computing, electronics and business management. Another company, the Apollo Group, offers masters and bachelors programmes at over 100 campuses around the United States and in London. Both companies are listed on the NASDAQ stock exchange and have current revenues of around US$300 million each. They are part of a growing wave of listed education companies. The University of Phoenix, a subsidiary of the Apollo group, now has nearly 70,000 students; it operates in 12 locations and on the Internet and is one of America's largest universities.

Even larger companies are emerging in the US education market. Knowledge Universe, a new entrant with over US$1 billion in annual revenues, is seeking to redefine education provision. It is currently investigating buying either Apollo Group or De Vry to complement its preschool, school, tertiary and supplementary education services. The progress of such initiatives will influence our education system in the future as it develops new delivery techniques, synergies and cost structures.

Similar developments are occurring in other countries, including in the schools sector. In Britain, chains of for-profit schools are being set up. The largest of these, Nord Anglia, has 24 schools in Britain and Eastern Europe and is listed on the sharemarket. In India the for-profit National Institute for Information Technology has 400 campuses and is now expanding into 18 other countries including China, Malaysia, Indonesia, Botswana and even the United States.

These overseas trends illustrate the likely outcomes of greater private sector involvement in tertiary education. New organisational forms, including listed companies and community trusts, are likely to develop. The opportunities provided by a freer market will support a greater variety of organisations, some with different approaches. These are the types of benefits to which the public needs to be exposed.

Of course, PTEs have already innovated through course type, length, qualification, price, quality and resource mixes. New entrants will not have an easy ride, but it would be foolhardy to believe that current providers are operating at the highest possible levels of productivity. PTE managers should seek new ways to develop their services, just as they have managed to improve the provision of Training Opportunities Programme (TOP) and Skill Enhancement programmes.

Unfortunately, there are still obstacles in the way of innovative organisations. One of the New Zealand Association of Private Education Providers members, the Sir George Seymour National College of Tourism and Travel, recently won two prestigious awards – one for education in the tourism industry and the other for its achievement in marketing its services. Such success should lead to significant increases in enrolments, but under the current rules the College would be unable to secure a higher level of government funding. That major constraint will change next year, but we should be trying to remove all impediments to the sector's performance.

The Tertiary Education Review

The current Tertiary Education Review has been too restrictive in exploring what the nature and scope of government intervention in tertiary education should be. This work needs to be done so that the whole regulatory framework is re-examined afresh.

The aims of the Tertiary Education Review Green Paper were unclear. They included higher participation in tertiary education but no case for that goal was set out. Quite clearly more of anything is not necessarily better beyond a certain point, even something as important as tertiary education. Another aim was to increase the proportion of Maori and Pacific Islands people in tertiary education but there were no policies for targeting assistance to such groups. The Green Paper suggested that the government retain ownership of TEIs without offering any arguments for doing so. More basic questions need to be asked about the government's role in this industry.

Regardless of this confusion over the aims of its policies, the government has come up with some useful initiatives, some of which were announced in the latest budget. The most important of them is opening up the tertiary education sector to competition through more equal subsidies for PTE and TEI students. That should lead to a mix of lower costs, higher quality and greater choice for consumers, but more work needs to be done on funding, ownership and regulatory policies to enhance those benefits.

Funding should be reduced over time to levels that can be justified on public policy grounds. Subsidies should be related to the public good element of courses. As Milton and Rose Friedman have put it:

> The present use of tax monies to subsidise higher education seems to us one of the great suppressed scandals of our day. The young men and women who go to college on the average come from higher-income families than those who are not in college – yet both sets of parents pay taxes. And, whatever the income of their parents, those young men and women will occupy the higher rungs of the economic ladder. Indeed, *we doubt that there is any other government program that so clearly and so massively transfers income from relatively low- to relatively high-income classes.* We in the middle income classes in effect have conned the poor into supporting us in a style that we take to be no more than our just deserts.

It is extraordinary that those who profess to be concerned about inequality in New Zealand are not the most vocal opponents of such an inequitable transfer. Equity objectives in higher education are better served by scholarships or loans.

The priority accorded to government ownership should be reversed in favour of private ownership. The current TEIs should be either sold or restructured as private not-for-profit trusts, as Sweden has done with two of its universities. If state ownership of those institutions is retained, their governance arrangements should be changed. Governing bodies need to have the expertise to oversee the strategies of TEIs and monitor their managers' performance in achieving them. The current representative model does not adequately meet that requirement.

The government must also curtail the scope of its regulation. Entry barriers should be reduced, not increased through the excessive financial accountability requirements and examination of detailed business plans proposed by the Ministry of Education.

The coverage of the National Qualifications Framework should also be limited and be made voluntary. Such a Framework may be suitable for some students and for some providers but certainly not for all. The danger is that the government will choose to maintain and increase the Framework's coverage in its White Paper. This would disregard individuals' choices over course quality and impose high compliance costs.

The government still needs to make high-level decisions about its role in regulating the tertiary education industry. Providing the necessary advice may be beyond the capacity of the Ministry of Education and require outside experts to review current proposals. This might delay final decisions for a short time, but it could result in higher quality decisions.

The future

The Universal Tertiary Tuition Allowance (UTTA) opens up many opportunities for PTEs and TEIs to better meet the needs of businesses and students. There will be fewer inequities in resourcing arrangements between PTEs and TEIs, and student demand – rather than bureaucratic forecasting – will drive resourcing. These initiatives are necessary, but not sufficient, to meet the expectations of businesses.

Businesses do not want to pay high taxes to subsidise an off-job education system when on-job training is more effective. Businesses are also wary of the inefficiencies that unnecessary regulations are likely to create in private and public organisations. PTEs will be subject to some of the same incentives as TEIs to raise the barriers once they are allowed on to the playing field. Such new barriers to competition should not be allowed to distort what could become a dynamic part of our economy. The PTE sector must continue to press for a level playing field in order to meet its customers' needs – both those of students and businesses.

If we can secure the gains of better funding arrangements without imposing new and costly regulatory barriers, we can look forward to significant improvements in the effectiveness of the tertiary education sector overall. In such an environment the private sector could lead the way in terms of innovation and effectiveness and be assured of a bright future.

UNIVERSITY OF AUCKLAND WINTER LECTURE SERIES
'THE UNIVERSITY IN THE 21ST CENTURY'

ACADEMIC FREEDOM AND UNIVERSITY ACCOUNTABILITY

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NEW ZEALAND BUSINESS ROUNDTABLE

AUCKLAND
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ACADEMIC FREEDOM AND UNIVERSITY ACCOUNTABILITY

From the idea of academic freedom we can, I believe, construct an image of the ideal university. Academic freedom flows from an absolute commitment to truth and knowledge, a commitment that is the essence of the university. To fulfil this commitment, all members of the university community implicitly accept an obligation to respect freedom of thought, inquiry and speech and to defend it from attempts to interfere with it, from within or without, subject only to the general laws prohibiting libel, slander, incitement and breach of copyright, as well as the rules of good manners. The ethos of the university should be one of uninhibited intellectual curiosity and engagement.

We can to some extent formalise the idea of academic freedom for the purposes of the different members of a university. I take it that the topics on which academic staff teach courses are determined by the established processes of governance, but the staff have complete freedom over the content of their lectures, subject to whatever accountability procedures apply. In other words, having been engaged to teach a course, an academic is not subject to censorship. Staff are hired not because they hold views that are approved of (or not hired because their views are disapproved of), but are judged only in the light of proven professional ability as teachers or researchers. In the same spirit, students are graded not according to the views they hold, but according to the quality of the arguments that they bring to their defence. Guest speakers invited on to the university campus are entitled to be accorded the same academic freedom as the members of the university. Any university that does not uphold academic freedom against any threats to it should automatically suffer a loss of prestige and reputation.

What I have said so far seems to me to be elementary and uncontroversial. And yet it is not in these terms that academic freedom is usually discussed in New Zealand. Rather, academic freedom in New Zealand is associated with the universities' role as "critic and conscience of society", a role enshrined the Education Act 1989. For example, in its Tertiary Education Review, published in September 1997, the Ministry of Education states that the government should use the Crown's ownership interest in tertiary education institutions (TEIs) to ensure, among other things, "protection of the tradition of academic freedom". It goes on to define academic freedom as:

> … the role of academic staff to act as critic and conscience of society under which they question and test received wisdom, put forward new ideas and challenge orthodox, or state unpopular, opinions.

It later suggests that governing bodies of TEIs should be responsible for "promoting the national and international reputation of the TEI in terms of the quality of its education and related services, its research, and its performance as critic and conscience of society (academic freedom)".

Similarly in its response to the Tertiary Education Review, the New Zealand Vice-Chancellors' Committee said that:

> University academics themselves are under an obligation to bring to public attention, through public debate, issues on which they have a contribution to make informed by their research. Not all criticism need be adverse. But the tension between universities being, on the one hand, funded by the state, and, on the other, free to challenge the state is an accepted and important tradition to be maintained.

The Committee went on to claim that:

> Through this tradition universities play a fundamental role in maintaining freedom of expression and thought in a democratic society.

Let me make it absolutely clear that I totally endorse and value the involvement of university academics in public debate. Indeed I often wish some of our best academics would speak out with more vigour and courage on public issues. For example, I think it has been disappointing that although many legal academics privately deplored the judicial adventurism of the Court of Appeal under Sir Robin Cooke, few were prepared to make their views known publicly (Professor John Smillie of the University of Otago being perhaps the most notable exception). The excuses offered were that they were afraid of upsetting the judiciary, their university chancellors (sometimes judges) or those responsible for research grants or consultancy contracts. I can understand legal practitioners being reticent about criticising judicial performance – they have to appear before judges and think about their clients' interests. But things have surely come to a pretty pass if academics to whom we explicitly grant academic freedom in the interests of protecting free inquiry and expression are not prepared to exercise it.

I also think it is unfortunate that many of our best academics are not the ones the public typically hears from. Often they are concentrating on research and publication in quality journals, not in newspaper columns. It tends to take an egregious piece of writing by one of their more outspoken colleagues to spur them into going public with an account of the more accepted insights of their disciplines.

So the argument is not about the values of academic freedom nor the legitimacy of academic involvement in public debate, but about conflating the two separate issues. I take a sceptical view of the association between academic freedom and the universities' role as "critic and conscience of society". My scepticism arises initially from three questions. First, in a society in which basic freedoms, including those of speech and conscience, are secure and even protected by a Bill of Rights Act 1990, why should 'academic freedom' be singled out for special statutory protection? Would academic freedom seriously be threatened if it were not explicitly protected by the Education Act 1989? Surely, of all people, academics are well placed to speak their mind without fear of the consequences. Why then does academic freedom receive this special protection?

Second, if universities are to play the role of critic and conscience of society, whose job is it to criticise the universities? It's a central principle of procedural fairness that no one can be a judge in their own case. Presumably the universities do not wish to claim that they are infallible or that they should be exempt from outside assessment. But if they wish to retain a special role as social critic and conscience, they should surely welcome moves to subject them to external assessment of their own performance. And if academics participate in public debate, which I repeat I welcome, there can be no basis for complaint about others responding to and criticising their arguments.

Third – and this goes some way to answering my second question – if there is to be a legally prescribed role of "critic and conscience of society" (and I must admit to being at one with the political philosopher Kenneth Minogue in finding the idea "faintly totalitarian" – I wonder what George Orwell would have made of it), why should this be exercised only by universities? The law does not forbid other institutions or persons from playing that role, though no other institution enjoys similar statutory protection. But in a free society, social criticism can, and does, come from a variety of sources: from the media, the churches, the professions, think tanks, business, voluntary associations and from private citizens. So if there is to be a special protected role for universities, and above all if state subsidies are involved, let that role be contestable. After all, many other functions that are closely associated with universities are contestable. Much university research funding, for example, comes from contestable sources like the Public Good Science Fund, that also supports the research activities of other bodies like the Crown Research Institutes. Society is entitled to say whom (if anyone) it wants to subsidise to be its "critic and conscience".

I believe the view I am putting forward is in accord with the traditional view of the nature of the university, as best expressed in modern times by Cardinal J H Newman, an Oxford University don who helped found the University of Dublin in the mid-nineteenth century. In 1852 Newman published a famous series of lectures under the title *The Idea of a University*. For Newman, the university existed to protect the life of the mind, and to preserve the accumulated wisdom of the past. The value of the university was that it inculcated in its members what he called "A habit of mind … which lasts through life, of which the attributes are freedom, equitableness, calmness, moderation and wisdom" – or what "I have ventured to call a philosophical habit". Although Newman rejected the utilitarian view that knowledge was valuable only if it was useful in some instrumental sense, he did not oppose universities becoming involved in research and training in the professions. But as these activities could be and were undertaken also by other institutions, Newman identified "the philosophical habit" as the "the special fruit of the education furnished at a University, as contrasted with other places of teaching or modes of teaching".

Universities like to cite Newman's work as setting out their *raison d'être* as places where knowledge can be acquired, and mankind's intellectual heritage preserved, for their own sake. But you will notice that this conception of a university recognises or prescribes no role of critic and conscience of society. On the contrary, Newman was trying to preserve the original medieval nature of universities as extensions of the monasteries, places where people went to get away from society and to find the calm and tranquillity that are necessary for cultivating the intellect. To a very great and remarkable degree, the structures and even the architecture of modern universities reflect their medieval origins. Even if the extreme social detachment of the universities that Newman valued is inappropriate in these less deferential times, academics are likely to be of more value to society by pursuing knowledge than by taking on 'socially relevant' functions.

Where then does the view of universities as society's critic and conscience come from? It is a relatively recent idea, and has its origins in the German university tradition rather than the British one. A major expression of this tradition is the 1923 book *The Idea of the University* by the German philosopher Karl Jaspers. For Jaspers, the essential role of the university in generating new knowledge included articulating and formulating a nation's culture, and from this the role of critic and conscience of society flowed quite naturally. But it is deeply ironic that Jaspers' book should have appeared when it did, for soon afterwards the German universities started to become major centres of a vigorous and well-known source of criticism of German society, namely, the Nazi party. In the 1920s, the Nazis seemed to be little more than a fringe rabble of revolutionary ex-soldiers who wouldn't accept that the Great War had ended. By the early 1930s, they were sufficiently mainstream and respectable to enable Hitler to come to power by constitutional means, and the universities had certainly done their bit to make that possible. One of the chilling features of the history of the university in the twentieth century is the support among German academics for the suppression of liberty that the Nazi programme entailed, although of course many academics, including Jaspers himself, opposed the Nazis.

This example may seem rather extreme, but it helps illustrate my deepest objection to the "critic and conscience" role for universities. Recall the Tertiary Education Review's claim that this role involves academic staff questioning and testing "received wisdom", challenging "orthodox" opinions and stating "unpopular" ones. This claim conjures up an image of the universities as fragile beacons of enlightenment, defending truth and reason from the menacing forces of mass ignorance and bigotry. This image may be flattering to academics, but it is, I submit, nonsense. In any society, public debate is dominated, not by popular opinion, but by elite opinion. Elite opinion may or may not coincide with popular opinion. But my point is that *it is always harder to argue against elite opinion than against popular opinion*. Take capital punishment. In many countries, convicted murderers are not executed, because elite opinion is against capital punishment, even though the general public is for it. But is it easier for an academic to oppose capital punishment than to defend it? Obviously it is. Or take the proposition that the rise in the number of people on welfare benefits over the last decade is a predictable effect of unconditional, or at least easy, eligibility for state welfare. I do not know whether that is a popular view or not. But it would require more courage to argue publicly for the proposition than against it, because to do so would be to challenge the opinion of the educated elite or a substantial part of it.

The extreme case of the dominance of elite opinion is, of course, the phenomenon of 'political correctness'. A major problem with political correctness is not the content of the opinions involved, but the fact that they are held so self-righteously that criticism of them is denounced and silenced rather than answered. In other words, political correctness is the exact antithesis of academic freedom. An associated problem is that 'incorrect' views are attributed to people who may not in fact hold them. Thus, opponents of biculturalism or of liberal immigration policies risk being denounced as 'racist'; opponents of employment quotas for women risk being denounced as 'sexist'; and advocates of rigorous and objective standards in education risk being denounced as 'elitist'. Where free speech is policed in this way, its cost is raised and there will be less of it. But if this is true of universities, then the blame must lie primarily with those academics who allow themselves to be intimidated into silence. Academics are unique in having the costs of their free speech *lowered*, not only by the protection of academic freedom but in many cases also by security of tenure. If they still don't speak out when they would otherwise be inclined to, they are guilty of a lack of moral and civic courage.

Political correctness is a far more insidious threat to academic freedom when it is enshrined, as it sometimes is, in university 'speech codes', since staff and students alike can be threatened with disciplinary action for breaching them. Such codes apply in some universities in the United States. Their ostensible aim is to prevent university members from making 'insensitive' remarks (typically, it is the sensibilities of groups espousing the 'politics of difference' that are protected – less concern is shown for the sensibilities of white, Anglo-Saxon, heterosexual, middle-class, Christian males, especially dead ones.) It's hard to think of a more blatant way of attacking the academic freedom of both students and staff than by imposing a 'speech code' designed to control the use of language. This amounts to a throwback to the totalitarian regimes that tried to impose officially approved vocabularies as a means of making politically incorrect thoughts literally unthinkable. In civilised societies, people's legitimate sensibilities are adequately protected by general laws and the conventions of etiquette; anyone who finds that amount of protection insufficient is not suitable for university life.

As far as I am aware, we have not seen attempts to introduce speech codes in New Zealand universities, but we must be aware of the danger of the campus becoming, as US educationist Chester Finn has put it, "an island of repression in a sea of freedom". There are too many reports of alleged politicisation of scholarship, of attempts to impose Asian and Maori studies as compulsory courses, of academic staff privately disagreeing with politically correct initiatives but staying silent about them, and of students opting to express views acceptable to lecturers rather than their own in order to get good grades, for us to be complacent. My strong impression is that the most perceptible current threats to academic freedom are from within the university not without.

To be sure, the commitment to academic freedom can be demanding. It means protecting the freedom to argue for unfashionable propositions, such as that the greenhouse effect is either non-existent or a good thing; that marital separation is harmful to children; or that intelligence may be unevenly distributed across races. And yes, it also means protecting the freedom to argue propositions that I would strenuously contest, such as that import tariffs protect employment, or that more welfare spending would automatically promote social justice. But freedom to say uncomfortable or irritating things is precisely what academic freedom is all about, and precisely what universities exist to protect.

How, if at all, should the law relating to universities explicitly protect academic freedom? As far as the "critic and conscience" provision in the Education Act 1989 is concerned, I think it would be best if it were repealed and individual universities decided for themselves whether they wanted their staff to accept such a role. What should concern the universities about this role, whether or not it is enshrined in law or regulation, is accountability. Lewis Evans, a professor of economics at Victoria University of Wellington, has observed that:

> At the very most, the role of critic and conscience of society must be secondary to the primary goal of quality research. It may actually inhibit research quality and undermine the values and goals of the university system by legitimising the involvement of university staff in wide-ranging public debate as part of their university employment, whether or not such debate is in the area of their research and even if they have no credible research record.[1]

It seems to me that a university that values its reputation would jealously control the use of its name by its members. For example, academics wishing to criticise publicly the government's economic policies would do so in their professional capacity (citing their university positions) only if they had the recognised qualifications and reputation in the discipline of economics, otherwise they would be expected to do so as private citizens. In this way, their criticism would not only carry the weight due to a member of their university, but it would be properly constrained by the exposure it brought them and the risks it posed to their professional reputations. As it is, as Professor Evans suggests, academic anthropologists or archaeologists may criticise official economic policies in their professional capacity, and even claim it is their duty to do so under the "critic and conscience" clause, yet suffer no penalties or loss of reputation if their criticism is completely fatuous.

Beyond that, universities could consider bolstering academic freedom, if they thought it necessary, by drawing up codes of academic conduct. It would seem to me to be perfectly acceptable to require staff and students, on becoming members of a university, to sign an agreement to respect and uphold academic freedom, on the understanding that they risk expulsion or other sanctions if they break that agreement. I had the experience of having an honorary lecture that I gave at Massey University last year, attended by the vice-chancellor and senior academic staff, disrupted by a student association group protesting against the government's fees policy. The most common reactions I received from students and staff after the lecture were "so much for academic freedom at this university", and "that's the best argument you've ever heard for voluntary student unionism".

I have been arguing that any threats to academic freedom in the current environment are more likely to come from within universities rather than from outside. In fact, what is striking in New Zealand is how much the government respects the autonomy and independence of universities and how little it attempts to influence the content of teaching and research, even where many questions could be asked about its quality. No one has been able to give me any example of government intrusion into this area in living memory. Nor do I believe the government's proposals for enhancing accountability as set out in the Tertiary Education Review threaten academic freedom. I agree with Professor Michael Irving, vice-chancellor of Victoria University of Wellington, that even if most or all members of universities' governing councils were appointed by the government, "Most appointments would be university graduates who would value academic freedoms and the rights of academics and students".[2]

Nevertheless, a future generation of politicians could take an entirely different attitude. There is very extensive government involvement in the universities, especially in financing them. Yet most university staff and students seem to support this state of affairs, largely because they believe it protects their academic freedom by ensuring their independence from the potentially corrupting influence that private ownership or finance would bring.

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1 'The Quest for Quality in Universities', *Agenda*, Vol 4, No 4, 1997, p 401.
2 *NZ Education Review*, 22 April, 1998.

What this viewpoint overlooks is the homogeneity in structure and governance of state universities and the constraints on diversity, the controls always associated with government funding, and the potential threat that government monopoly poses to the very survival of academic freedom. Compare the uniform New Zealand university system with the American one, which includes state-owned, privately-owned, non-profit and for-profit institutions. The system combines many of the world's top universities as well as mediocre ones, but overall is rated by most observers as the best in the world. Surely no one could seriously argue that academic freedom is threatened by such competition and diversity.

This observation is hardly original. In mid-nineteenth century Britain it seemed self-evident to many observers that the expansion of education should be left predominantly to civil society rather than government. In his 1859 classic *On Liberty*, John Stuart Mill argued that "Government operations tend to be everywhere alike. With individuals and voluntary associations, on the contrary, there are varied experiments, and endless diversity of experience". He went on:

> Every function superadded to those already exercised by the government causes its influence over hopes and fears to be more widely diffused, and converts, more and more, the active and ambitious part of the public into hangers-on of the government, or of some party which aims at becoming the government. If the roads, the railways, the banks, the insurance offices, the great joint-stock companies, the universities, and the public charities, were all of them branches of the government … if the employees of all these different enterprises were appointed and paid by the government, and looked to the government for every rise in life; not all the freedom of the press and popular constitution of the legislature would make this or any other country free otherwise than in name.

This view was almost universally accepted at the time. Even Karl Marx believed that government should have no role in the direct provision of education.

The Vice-Chancellors' Committee, in the passage I quoted earlier, remarks on the "tension between universities being, on the one hand, funded by the state, and, on the other, free to challenge the state". Over time, that tension could be resolved in the interests of the state unless the universities take steps to free themselves from their excessive dependency on state funding. Precedents already exist close to home. In Australia and Britain, reforming governments in the 1980s abandoned any pretence of deferring to the views of Cardinal Newman. They centralised their university systems and greatly extended bureaucratic control over them, for example by requiring research grants in appropriate disciplines to be dispensed in the light of politically determined 'national priorities'. In such circumstances, as Mill noted, legal freedoms can coexist alongside actual loss of freedom. Morale among academics is low in Australia and Britain, not just because much of their time is wasted in filling in bureaucratic forms that are supposed to substantiate various meaningless 'performance indicators', but also because they are trapped in a cage of their own making. So long as they remain wedded to exclusive state ownership and funding of universities, they will face increasing demands from governments that are rightly accountable to electorates through the democratic process. With the so-called 'massification' of higher education, governments will not be prepared to throw more and more taxpayers' dollars over the ivory wall without introducing stricter control mechanisms to satisfy themselves that they are getting value for money. Perhaps it will fall to a future generation of academics to realise the liberating effects of multiple and competing types of institution and sources of finance.

The trend to 'massification', in so far as it affects universities, also has implications for academic freedom. To a much greater extent than ever before universities are catering for vocational training, and there are at least two consequences of this trend. First, universities find it increasingly difficult to turn away students for whom their traditional academic training, emphasising the life of the mind for its own sake, is unsuitable and, secondly, they become increasingly beholden to employers. It may be argued that universities have always served the vocational purpose of training students for the clergy, some other professions and the administration. This is true, but it was a contingent feature of universities that had been created out of a passion for scholarship – a passion that in fact distanced them significantly from the practical concerns of society at large. But this emphasis on a contingent aspect of university life, in substitution for its essence, has led to an increasing trend towards the vocational in the belief that this would enhance national prosperity. And some of our universities, with their territorial ambitions, do not seem at all adverse to this trend. However, a consequence has, I suggest, been to weaken the autonomy of universities with very uncertain benefit in terms of national prosperity. Vocational training is vital and deserves parity of esteem with academic education, but there must be ongoing debate about the extent to which it is the business of universities, not least from the perspective of academic freedom.

I believe a good case can be made that full independence from government control offers universities the best long-run guarantee of academic freedom. The Nobel laureate in economics George Stigler, an intellectual's intellectual if ever there was one, had this to say about his own academic experience:

> If one asks where, in the Western university world, the freedom of inquiry of professors has been most staunchly defended and energetically promoted, my answer is this: not in the politically controlled universities, whether in the United States or Germany – legislatures are not overpopulated with tolerant men indifferent to popularity; and not in the self-perpetuating faculties, such as Oxford and Cambridge from 1700 to 1850 – even intellectuals can become convinced that they have acquired ultimate truth, and that it can be preserved indefinitely by airing it before students once a year. No, inquiry has been most free in the college whose trustees are a group of top-quality leaders of the marketplace, men who, experience shows, are remarkably tolerant of almost everything except a mediocre and complacent faculty. Economics provides many examples: if a professor wishes to denounce aspects of big business, as I have, he will be wise to locate in a school whose trustees are big businessmen, and I have.

While I am not an academic, I have to say that my experience in an organisation of major business firms has been of a similar freedom to undertake research and pursue the logic of analysis in a remarkably unconstrained way.

As New Zealand society ages and pressures on public spending grow, future governments may face increasing temptations to bend the universities to their will, and to make them instruments of their policy goals, in ways that inevitably threaten academic freedom. Their best defence against this possibility is not to stand aloof as the barely noticed "critics and conscience" of society but to seek increasing independence from government financing, ownership and regulation. I would like to think that in the next decade or so we will see moves in the direction of a more diversified, independent, vibrant and self-confident university system in New Zealand, in which the best of our academics enjoy and exercise their academic freedom.

SOCIAL POLICY

NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE ACCIDENT INSURANCE BILL

OCTOBER 1998

SUBMISSION ON THE ACCIDENT INSURANCE BILL

1 Overview and recommendations

Overview

1.1 This submission on the Accident Insurance Bill (the Bill) is made on behalf of the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand firms. The organisation's purpose is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 The NZBR welcomes the key reform set out in the Bill. Opening up the Employers' Account to competition is a step in the direction that the NZBR has advocated since 1987.

1.3 Competition has a critical role in forcing suppliers to identify and satisfy customer needs at least cost, and in price discovery. Conferring a statutory monopoly on the Accident Compensation Scheme (the ACS) was an error of disastrous proportions. That decision made it impossible to give the provider a clear, meaningful, single objective, such as a profit objective. It perpetuated Crown ownership of a politicised provider with multiple, conflicting objectives and eliminated the possibility of any mechanism for price discovery while massively weakening incentives to discover customer preferences. Another major mistake was the suppression of freedom of choice in relation to critical features of accident cover.

1.4 However, the measures in the Bill also contain flaws in respect of competition, ownership and freedom of choice. Much greater benefits for New Zealanders could be gained from more far-reaching reform than is contained in the Bill. The NZBR will shortly be publishing a detailed, independent analysis of these issues that will be made available to members of the Select Committee. In the NZBR's view, all other accounts should be opened to competition, the government should not own any provider of insurance, and individuals should be permitted to choose any terms they desire for any insurance contracts they wish to purchase. The Accident Rehabilitation and Compensation Insurance Corporation (ARCIC) should be closed and any related activities not privatised should be absorbed within the Department of Labour. In due course, there should also be a re-examination of liability (right to sue) issues, that are independent of choices made about insurance market arrangements.

1.5 Current restrictions on choice appear to be severe. Where they do not exist, as in the provision of private income replacement insurance, some people obviously prefer to insure against loss of earnings from accidents *or sickness*. Such policies remove all the related boundary issues that bedevil the ACS. Similarly, the policies sold demonstrate that many people do not require compensation at 80 percent of earnings or many other premium-increasing options that are mandated under the ACS. Consumer welfare can only be reduced when people are forced to buy features that do not represent, in their view, value for money.

1.6 Reflecting the findings of this analysis, this submission focuses on identifying areas in which the Select Committee could recommend modifications that would enhance competitive pressures and usefully reduce costs or improve incentives and choice, while preserving the main intentions of the Bill. For example, it may be possible to increase the scope for employers to opt out of the mandatory level of cover prescribed in the Bill, perhaps with the agreement of all the employees of the firm. Alternatively, if maintaining the current level of cover is seen as important for transitional reasons, greater gains in consumer welfare may be achievable by amendments that increase future pressures to remove restrictions on choice and competition that are currently intended to be transitional.

1.7 In our view, optimal tax arguments favour financing the unfunded liability associated with the ACS out of general taxation. From an efficiency perspective, the proposed variable levy on employers is a particularly inefficient, distortionary payroll tax. Proposals for any new tax should be subject to the disciplines of the government's Generic Tax Policy Process and this procedure has not been followed. Contrary to popular beliefs, the ultimate burden of a payroll tax does not fall on employers. In a competitive market place, the payroll-tax-inclusive cost of labour must be related to the productivity of the marginal worker. Since the tax cannot, by itself, improve the productivity of a given worker, it must tend to depress all workers' wages so that the total cost of the marginal worker continues to reflect that person's productivity. Where the tax reduces employment because some workers withhold their labour at the lower wage, gross wages may not fall by the full amount of the tax. In this case the burden of the tax will be likely to be ultimately met by consumers through higher product prices and by pre-existing employees through reduced wages and higher unemployment.

1.8 The Treasury argument that a risk-related payroll tax is efficient if it improves incentives to rehabilitate those who account for the outstanding liability is also flawed. First, if the government were serious about improving incentives to manage the tail, it would privatise this activity. This reform could be expected to be most efficacious in terms of that objective. Secondly, failing this reform it could, as owner, directly improve this aspect of the ARCIC's performance by requiring better contracting arrangements. Until recently it has failed to require the ARCIC to pay due attention to the rehabilitation objective. Thirdly, if, as manager of the tail, it wished to motivate employers to help with the rehabilitation of injured workers, it would do so on a commercial marginal benefit/marginal cost basis. No coercion would be required. For example, it might offer to pay employers who assisted in the rehabilitation of a specific injured worker an amount that reflected the employer's marginal cost and the marginal benefit to the manager in the form of the reduction in the scheme's liability to the injured worker. Such incentive arrangements would look very different from the proposed payroll tax and be much more efficient. As owner of the tail, the government could and should instruct the manager to devise incentives to employers that are commercially structured and reflect this balancing of costs and benefits.

1.9 In similar vein, the government should privatise the commercial government insurer as soon as private insurers are established in the market for workplace accident insurance. There is no justification for the continued presence of a government-owned insurer in the market, other than possibly as a transitional measure.

1.10 The Motor Vehicle and Earners' Accounts should be opened to competition as soon as possible. The government should also consider tendering its liabilities under the Non-Earners' Account to private insurers. Efficiency gains are likely to be achievable through bundling workplace, non-workplace and motor vehicle accident cover. Until the Motor Vehicle and Earners' Accounts are opened to competition, these gains cannot be made. There are currently significant cross-subsidies within the Motor Vehicle and Earners' Accounts. The NZBR believes that these cross-subsidies should be eliminated. However, if the government wants to continue to cross-subsidise individuals for social reasons, it should do so in a transparent manner.

1.11 The proposed government guarantee of benefits is a major policy error because it creates significant moral hazard problems and near-irresistible pressures to regulate so as to reduce the self-induced fiscal risks. It is folly for governments to underwrite any entrepreneurial business activity – witness the costs to New Zealand of the 'Think Big' projects and the Development Finance Corporation (DFC), Attempts to regulate in order to control the fiscal risks will be costly and will not necessarily be effective – as the disastrous experience in the United States with regulated and guaranteed savings and loans associations illustrates.

1.12 The government's guarantee of entitlements is the ostensible justification for the proposed prudential regime that is aimed at reducing the fiscal risks of insurer insolvency. Given this decision, the NZBR supports the government's attempt to retain a relatively light-handed disclosure-based regime. However, the best solution would be to review and remove the guarantee at the earliest possible date. The NZBR is not satisfied that the proposed mandatory use of trustee companies to monitor insurer solvency is better than alternatives that represent less of a subsidy for this sector.

1.13 The approach taken in the Bill to 'uninsurable risks' is preferable to the creation of an assigned risk pool for employers who cannot obtain a quotation. Assigned risk pools in other jurisdictions have tended to grow over time and in some cases destroy the primary insurance market. However, the Bill's requirement for all insurers to quote to all employers will increase insurer costs and may discourage entry of specialised insurers. It will not avoid problems of affordability for some employers, and insurers will find it difficult to price new risks for which there is no reliable history (such as new adventure-tourism activities). (However, the underwritten self-insurance option may be useful here if the employer has financial substance.) It should be viewed only as a transitional measure. The NZBR recommends that the government consider making the costs of the role of insurer of last resort transparent by tendering for the purchase of this service.

1.14 The remaining sections of this submission provide more detailed comment on the Accident Insurance Bill. We have concentrated on the following areas of greatest concern to the NZBR:

- Funding of the liability for past accidents
- Level of mandatory entitlements
- Continuation of non-competitive insurance
- Prudential supervision regime
- Establishment of a government-owned competitive insurer.

This submission does not comment on tax issues. We understand that the Insurance Council of New Zealand's submission raises some tax issues that may warrant consideration.

Recommendations

1.15 The following is a summary of the NZBR's recommendations:

General recommendations for more far-reaching reform

1 All Crown insurers should be sold or closed to new business beyond any transitional period (Section 7, particularly paragraph 7.4).

2 Benefits should be neither guaranteed nor mandated, at least beyond some transitional period (Section 3 and paragraphs 1.12 and 5.3).

3 The Motor Vehicle and Earners' Accounts should be opened up to competition as soon as possible (paragraph 1.10). A date no later than 12 months after the new arrangements come into effect is suggested.

4 The Non-Earners' Account should be tendered to private insurers within a similar timetable (paragraph 1.10).

5 Any remaining government involvement in workplace accident compensation should be a responsibility of the Department of Labour and any parts of the ARCIC that are not privatised would be transferred to the department.

Specific recommendations

6 The Bill should require the government to review its ownership of any accident insurance companies by July 2000 with a view to selling them or closing them to new business by July 2001 (Section 7, particularly paragraph 7.4).

7 The Bill should require the government to review its guarantee and mandated entitlements at the same time that it reviews its prudential regime (paragraphs 1.12 and 5.3 and Section 3).

8 Part 10 of the Bill should be amended to include the following provision:

> The Crown will allow insurers to offer contracts for all types of accident insurance from 1 July 2001 and will allow individuals to opt out of cover provided by the statutory manager (paragraph 4.1).

9 Consideration should be given to allowing employers to opt out of the mandatory level of cover prescribed in the Bill, possibly subject to obtaining the agreement of all the employees of the firm (paragraph 1.6 and Section 3).

10 The self-employed should be permitted to take any level of cover they desire (paragraph 4.5). Failing this, boundary problems between non-earners and low-income earners may need to be addressed by shifting the boundary and introducing an income threshold below which the self-employed are covered by the Non-Earners' Account (paragraph 4.6).

11 The tail should be funded from general taxation – Option D – unless an alternative approach is shown to be superior as a result of following the requirements of the Generic Tax Policy Process. If the tail is to be funded by a temporary payroll tax, that tax should not be risk-related (paragraphs 1.7–1.8 and Section 2).

12 As owner, the government should instruct its managers to devise commercially structured incentives to employers who assist it to reduce the tail (paragraphs 1.8 and 2.6).

13 The government should openly and transparently fund any desired cross-subsidies (paragraphs 1.10 and 4.7–4.8).

14 The requirement for all insurers to quote to all employers should be reconsidered and at most established as a transitional measure. Instead the government should consider tendering the role of insurer of last resort (paragraphs 1.13 and 4.9–4.10).

15 Further consideration should be given to 'light-handed' regulatory options that would not confer so much business on trustee companies. In particular, consideration should be given to tendering the role of monitoring insurers (Section 5, particularly paragraph 5.2).

16 Insurers should not be required to contribute to the Insolvent Insurers Fund. General taxation should be used to fund any such amounts (Section 6, particularly paragraph 6.4).

17 Insurers should not be obliged to contribute to any Non-Compliers Fund. Instead the Non-Compliers Fund should be funded from penalties imposed for non-compliance and general taxation (paragraph 6.6).

2 Funding existing claims

2.1 The Department of Labour estimates that the discounted future cost of existing claims on the Employers' Account is $5.5 billion.[1] One of the most important decisions associated with the shift to competitive provision of workplace accident insurance is how to fund this liability. The government has proposed that employers fund the costs of the liability over 15 years through an employer levy. As explained below, the NZBR believes that this option will significantly reduce economic efficiency. It should be noted that while employers would initially pay the levy its ultimate incidence would be likely to rest with employees and consumers as firms adjust their operations to maintain competitive returns on investment. Thus our criticism of the proposal is not primarily motivated by a desire to relieve employers of an additional impost.

2.2 The government considered four options for funding the liability involving different balances of employer levy and general taxation.[2] The method favoured by the government, Option A, imposes all the costs of the liability on employers. Employers will be required to cover the liability associated with workplace injuries from 1974 to 1999 ($4.4 billion) and that associated with non-workplace accidents from 1974 to 1992 covered by the Employers' Account ($1.1 billion). Option B would impose the $4.4 billion liability associated with workplace injuries on employers. Option C would require employers to pay a levy for the ongoing costs of workplace accidents from 1992 to 1 April 1999 ($2.2 billion). The rest would be funded from general taxation. Option D would fund the entire liability from general taxation. In the terms of established government policy, any proposals for a new tax should be subject to the Generic Tax Policy Process.

2.3 The NZBR supports Option D. The second-best option is Option C. The method of funding the $5.5 billion liability has no effect on incentives affecting workplace safety. Imposing costs on employers for past accidents will not encourage them to avoid future accidents. The unfunded liability is a sunk cost. If the government's goal is to fund the liability as efficiently as possible, it should raise the funds in a way that least distorts decision-making. The deadweight costs of taxation are generally minimised by using broad-based taxation. This suggests that the funds should be raised from income and consumption taxes. New Zealand's tax system does not currently include payroll taxes. If the deadweight losses of payroll taxes were lower than those associated with income taxes and consumption taxes, the

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1 CAB (98) 367, 'ACC Reform: Funding of Existing Claims', 18 June, 1998.

2 The four options are set out in CAB (98) 367, 'ACC Reform: Funding of Existing Claims', 18 June, 1998.

government should raise revenue with a payroll tax, irrespective of the ACS issue. Payroll taxes are also likely to be less efficient than a hypothetical tax on labour income, which the treasurer and the then minister of finance (Rt Hon Bill Birch) suggested in correspondence with the NZBR, which may have some desirable properties as a tax. This is because a payroll tax misses important parts of labour income – for example, problems arise in determining whether self-employed income (such as farm income) is a return on labour or on capital. Instead, the minister's concerns about the burden of tax would point to the desirability of a flat(ter) income tax and reduced government expenditure. The fact that the government has not previously argued that payroll taxes are efficient and does not even now propose a *permanent* payroll tax on efficiency grounds suggests its current proposal is unprincipled and opportunistic. An earlier payroll tax, introduced by the then Hon R D Muldoon as minister of finance in 1970, was scrapped by the third Labour government in 1973 and it has never been revived. Imposing (or retaining) a payroll tax seems particularly inappropriate when unemployment is rising.

2.4 The Treasury supports Option A, under which employers pay the full liability over 15 years through a risk-related levy. The Treasury argues that employer funding of the liability would:

> … place greater incentives on employers and industry organisations to apply pressure on ACC to rehabilitate injured employees faster and more cost effectively, especially where employers can point to better management by insurers under competition.[3]

From an optimal tax viewpoint a variable payroll tax is even more inefficient and distortionary. It will discriminate against the employment of labour in firms that officials deem to be of high risk on the basis of historic costs, such as firms in the construction and forestry industries. There is no efficiency reason to impose a greater proportion of the tax on employees in higher risk industries. Such industries are unlikely to have more opportunities than low risk industries for returning claimants to work. There are much better options for rehabilitating claimants as discussed in paragraph 1.8. The employer levy will remove much of the incentive on the government to reduce the tail.

2.5 Individual employers will have extremely limited ability and incentives to monitor management of the tail. If they spend time and money monitoring the size of the unfunded liability, the benefits will be shared among all employers. The government should focus on improving its own monitoring ability. It should not impose an inefficient tax on employers (and indirectly, employees) because of weaknesses in accountability for dealing with long-term claimants.

2.6 The government should tender out the case management of the tail to private sector providers. It would not be difficult to design the contract to provide case managers with incentives to ensure that only claimants who met the eligibility requirements under the Bill continued to receive compensation. We note that in responding to the NZBR's criticisms of the government's decision to impose a payroll tax, the treasurer and minister of finance did not attempt to justify it in terms of the Treasury's position.

3 Entitlements

3.1 Part 5 of the Bill sets out who is liable to provide statutory entitlements to eligible persons. Schedule 1 to the Bill describes the statutory entitlements. The retention of mandatory entitlements in the Bill prevents employers and employees who

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3 Officials Paper to Cabinet Strategy Committee, Funding of Existing Claims, 12 June, 1998, p 6.

might prefer to insure for a lower level of risk from doing so. Mandating entitlements above the level desired by employers and employees forces employers to pay for something that is not valued by their employees. The cost is likely to be passed on either through reductions in the wages of existing employees – reducing the attractiveness of employment at the firm – or through adjustments in the numbers employed, leading to higher unemployment. Accident insurance premiums are a cost of hiring labour for employers and will be taken into account when employers consider whether to hire additional staff.

3.2 The mandatory entitlements in the Bill are set so high that many employers and employees are likely to prefer to opt out of some of them. For example, insurers' use of measures such as employee co-payments will be limited by regulations. Deductibles and co-payments are common methods used to reduce adverse selection and moral hazard in insurance markets. Restricting their use is likely to increase premiums unnecessarily. Weekly compensation is set at 80 percent of the insured's weekly earnings. In other insurance markets, such as that for income replacement cover, insurers tend to offer a range of deductibles, co-payments and stand-down periods with corresponding variations in premiums. Constraining the development of the accident insurance market by mandating entitlements at the current level will mean that a range of policies that are welfare-enhancing for both employers and employees will be ruled out. Consideration should be given to allowing employers to opt out of the mandatory level of cover prescribed in the Bill, possibly subject to obtaining the agreement of all the employees of the firm.

3.3 Section 151 in the Bill provides that:

> (1) An employer or a self-employed person or a private domestic worker may agree with an insurer that the employer, self-employed person, or private domestic worker will discharge any of the insurer's obligations under an accident insurance contract with that person.
>
> (2) The agreement does not affect the liability of the insurer to a person to whom the insurer is required to provide cover and statutory entitlements under the accident insurance contract.

The first of these provisions is commendable as it makes it possible for employers to self-insure for a particular level of claims if they have an insurance contract that will cover liabilities in the event of employer default. For many employers, this represents an improvement over the ARCIC's Accredited Employer programme.

4 Competitive provision of accident insurance

4.1 Part 7 of the Bill sets out the requirement for employers to enter into accident insurance contracts with registered insurers for work injuries suffered by employees. Motor vehicle injuries and non-workplace injuries will continue to be covered by the Accident Rehabilitation and Compensation Insurance Corporation, the non-competitive government insurer. As stated in the introduction to this submission, the NZBR welcomes the opening of the Employers' Account to competition but would like to see competition extended to include all non-workplace accidents. We propose the inclusion of the following section at the end of Part 10 of the Bill, which deals with non-competitive provision of accident insurance:

> The Crown will allow insurers to offer contracts for all types of accident insurance from 1 July 2001 and will allow individuals to opt out of cover provided by the statutory manager.

We note that officials from the Department of Labour and the Treasury recommended a similar approach to extending competition for all earners' out-of-work accidents in April, subject to further work on affordability, compliance, and transitional issues.[4]

4.2 Limiting competition to the provision of workplace accident insurance will unnecessarily restrict the scope for premium reductions and efficiency gains. Without the restrictions in the Bill, insurers would be likely to offer bundled cover to employers for a range of accidents.

4.3 The Bill's approach to self-employed accident insurance illustrates the problems created by cross-subsidisation in the Earners' Account for non-workplace accidents. Sections 143–146 allow self-employed persons to take out private insurance contracts for workplace and non-workplace cover. The Self-Employed Account (established under Part 10 of the Bill) will provide risk-rated workplace accident cover for self-employed persons who suffer work injuries in their self-employment and who do not have an accident insurance contract (Section 259). Non-workplace cover provided through the Earners' Account will continue to be a flat rate per dollar of income.

4.4 Self-employed persons who pay higher than actuarially fair levels of Earners' Account premiums are likely to opt out of the Earners' Account and take private insurance cover. Unless there is an increase in the flat rate premium levied on those earners remaining in the Account, there is a risk that an unfunded liability will arise in the Earners' Account. It is important that the Earners' Account be fully funded from premiums if the full gains from introducing competition are to be realised.

4.5 Instead of merely allowing the self-employed to opt out of the Earners' and Self-Employed Accounts, the government should allow the self-employed to opt out of having any accident insurance at all. There is no reason to require a certain level of accident insurance among the self-employed. Individuals are able to assess the relative costs and benefits of insurance and can assess their ability to control workplace risks. A self-employed person who did not take out insurance would be eligible to receive the invalid's benefit. Requiring the self-employed to insure to a particular minimum level reduces welfare. If they would prefer to insure at a higher level than the mandatory entitlement, they would do so voluntarily. If the mandatory level is higher than they would prefer, by definition they would gain from being permitted to opt out. Accordingly, the NZBR recommends that the Bill be amended so that the self-employed may take a lower level of cover than the mandated level and so that the government guarantee of entitlements for the self-employed extends only to the level of cover in an insurance contract that they choose.

4.6 Should the government not permit earners to opt out, boundary problems between non-earners and low-income earners are likely to prove increasingly troublesome if low-income earners are currently being subsidised by higher income earners and such cross-subsidies are progressively reduced. One interim option here would be to adjust the income threshold that defines the boundary between earners and non-earners so that earners with minimal income are covered by the Non-Earners' Account.

4.7 The Earners' Account is the only area of income-linked accident insurance cover that is currently not risk-rated in any way. Cross-subsidies in the account are likely to be substantial, particularly from high-income to low-income individuals (because of fixed costs of cover) and in favour of young males, who tend to be at

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4 STR (98) 70, 'Introducing Competition to Delivery of the ACC Scheme: Summary', 17 April, 1998.

greater risk of non-workplace sporting accidents.[5] There are strong arguments for risk-rating the Earners' Account so that people face the full costs of their risky behaviour. Arguments in favour of removing cross-subsidies for dangerous businesses are now widely accepted, and are reflected in the rest of the Accident Insurance Bill. Similar arguments apply in respect of non-work accidents.

4.8 If the government believes that there are offsetting social benefits from subsidising some risky non-work behaviour (eg high-risk sport), an explicit subsidy from general taxation revenue is preferable. This would make the current cross-subsidies transparent, improve the efficiency of funding the subsidies, and allow competitive pressure on premiums without adverse political consequences. Whether the government decides to reduce the existing cross-subsidies or not, it should stop underwriting Earners' Account insurance policies and contract out the management of claims in the Account to a private provider of rehabilitative services. As discussed in Section 2, the Corporation faces only weak incentives to return claimants to work under current arrangements.

4.9 Section 152 of the Bill requires insurers to provide insurance to any employer, self-employed person or private domestic worker. Although the section makes it clear that the insurer may set the terms and conditions (including the premium), the combination of a requirement to quote and the obligation on all employers to take out accident insurance at mandatory levels may create significant pressure to regulate prices. Employers will be required to accept a quote from one of the range of providers, regardless of the level. Some employers who have historically benefited from the cross-subsidies in the ACS may face the prospect of being forced out of business when they incur the true costs of their risky activities. Some such employers are likely to protest that they have been forced to take out unwanted insurance and that they and their employees would prefer to face the risk of accidents than pay the quoted price. Political pressure to regulate prices is likely to be strong. In the case of new risky ventures, the absence of a safety track record may force insurers to quote such high premiums as to cause the venture to fail before it has begun. Permitting self-insurance in such circumstances could improve welfare.

4.10 Instead of requiring all insurers to quote to all employers, the government could consider tendering the role of insurer of last resort. Requiring all insurers to quote is administratively simple, but it obscures one of the costs of mandating a high level of insurance cover.

5 Prudential supervision of insurers

5.1 Part 8 of the Bill sets out the regulatory framework and prudential regime for insurers in the accident insurance market. The combination of compulsory accident insurance for employers and a government guarantee of obligations means that a mechanism is needed to reduce the risk that insolvent insurers will enter the accident insurance market, default on their obligations and expose the government to the cost of ongoing claims. Without a government guarantee, policyholders have strong incentives to monitor their insurers and trade off lower premiums against the increased probability that the insurer will default. The existence of a government guarantee significantly lessens these incentives to monitor insurer performance.

5.2 The NZBR believes that the prudential framework for accident insurers set out in Part 8 of the Accident Insurance Bill will reduce the scope for competition and

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5 Officials estimate that participation in sports may raise claims costs relative to the average Earners' Account level by an average of 35 percent. See STR (98) 160, 'ACC Reform: Self Employed Issues', 17 July, 1998.

efficiency gains that could have been achieved had the government chosen not to guarantee obligations. The key mistake is the decision to provide a government guarantee. Given the decision to mandate cover and to provide a guarantee, the NZBR favours reliance on rating-related prudential requirements. Rather than confer so much business on a limited number of trustee companies, the NZBR believes that further consideration should be given to alternative arrangements that would allow the government to obtain the professional assessments it seeks while exposing it to the costs of obtaining these assessments. When successive governments must explicitly appropriate funds each year for an activity, they are arguably more likely to examine the rationale for the policies driving those expenditures than when they have used regulations to impose those costs on others. Since only the government can remove the source of the moral hazard problems (ie the guarantee), it is desirable that it be continually confronted with the costs that arise from the guarantee. That said, the NZBR supports the intent of the Bill to avoid many of the problems of heavy-handed regulation while keeping the risk to the government of insurer failure low. We agree with officials that trustees will have stronger incentives than regulators to tailor monitoring to the level of risk they perceive in an insurer, but it is surely possible to tender out such a monitoring role while maintaining such an incentive structure.[6] Actuaries could bid for such work, in competition with trustee companies.

5.3 The NZBR supports the proposal to examine the prudential supervision regime in 2003. However, we believe that the review should extend to the existence of the guarantee and the mandatory entitlements. The guarantee creates enormous moral hazard with little offsetting benefit. Unjustified distinctions exist between illness and accidents. Other forms of insurance are not compulsory and are not guaranteed by the government. The government does not mandate income replacement insurance for illness, nor does it guarantee such insurance contracts in the event of insurer failure. Employees who value income replacement insurance due to workplace accidents could negotiate such arrangements with their employers.

6 Insolvent Insurers Fund and Non-Compliers Fund

6.1 The Accident Insurance Bill establishes an Insolvent Insurers Fund (Section 203) and a Non-Compliers Fund (Section 223). These funds are proposed because the government is guaranteeing entitlements and is requiring employers to take out accident insurance cover. Part 9 of the Bill sets out requirements for employer, government and insurer contributions to the two funds.

6.2 The NZBR supports the limited requirement in Section 208 for an employer who was a party to a contract with an insolvent insurer to contribute to the Insolvent Insurers Fund. This increases an employer's incentive to monitor the financial performance of its accident insurer. However, the NZBR does not support the requirement in Section 209 for all insurers to contribute annually to the Insolvent Insurers Fund.

6.3 The Insolvent Insurers Fund is proposed because the government has guaranteed entitlements if an insurer fails. This, combined with a level of entitlements above that preferred by employers and employees, creates a risk of government liability if employers do not monitor their insurers and the insurer fails. Section 208 gives employers an incentive to monitor financial performance and switch insurer if they have concerns about solvency. In contrast, Section 209 imposes a cost on insurers without a corresponding improvement in incentives. Insurers will have little incentive or ability to influence insurer performance. Unlike employers,

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6 Officials Paper to Cabinet Strategy Committee, *ACC Reform: Accident Insurer Market Regulation*, 13 July, 1998, p 10.

insurers will not be able to avoid the levy if they suspect that an insurer will fail. The insurer levy proposed in Section 209 is a tax on prudence. It will raise the costs of participating in the market for accident insurance.

6.4 Instead of requiring insurers to contribute to the Insolvent Insurers Fund, the government should fund any such amounts through general taxation. If New Zealand's income and consumption tax structure is considered (approximately) optimal, funding the guarantee through general taxation revenue will be the most efficient method.

6.5 The NZBR supports Sections 216 and 233 of the Bill, which enable the Regulator to contract out the management of the provision of entitlements under the Insolvent Insurers Fund (s216) or the Non-Compliers Fund (s233), or to reinsure the liabilities of the Funds.

6.6 There is no efficiency-related reason for requiring insurers to contribute to the Non-Compliers Fund, as set out in Section 227 of the Bill. Fundamentally it is the government's responsibility to enforce its own laws. It has chosen to make the purchase of insurance mandatory. Insurers cannot make good any failure by the government to enforce its own rules. Taxing insurers for the cost of government failure is arbitrary, discriminatory and iniquitous. The NZBR recommends that the Non-Compliers Fund be funded from penalties imposed in respect of non-compliance and from general taxation.

7 The establishment of an insurer as a state-owned enterprise (SOE)

7.1 Given the government's decision to continue to provide accident insurance to employers in a competitive market, the NZBR supports the establishment of the insurer as a separate SOE. Governance arrangements in the SOE model reflect commercial operating conditions better than alternative arrangements. However, the NZBR does not believe that it is possible for a fully competitively neutral market to develop as long as a government-owned insurer operates in the market.

7.2 Many employers are likely to perceive the government-owned insurer as having an implicit government guarantee. It is not clear how the government plans to charge the SOE for this implicit guarantee. One option would be for the insurer to ask a rating agency to provide a rating based on non-government ownership. Alternatively, the board could tender a contract under which the successful bidder undertook to fulfil the Crown's obligations if the government-owned company incurred debts.

7.3 Establishing the competitive government-owned insurer as a SOE with a balance sheet, shares held by a minister and a profit objective will enable its board to monitor performance more readily than in the past. Political pressure on the company is likely to be great, and there is a risk that the government-owned firm will set prices below the actuarially fair level, for example if the shareholders are concerned about public reaction to significant premium increases for businesses that have historically been cross-subsidised.

7.4 The NZBR recommends that a section be inserted into the Bill that requires the government to carry out a scoping study on ownership options for the SOE in July 2000. The government has sold nearly all its other insurance companies in the last 15 years. Beyond any transitional period there is no reason for a government-owned insurer to be a participant in the accident insurance market and any such companies should be sold or closed to new business as soon as possible.

ACT NEW ZEALAND NORTH SHORE ELECTORATES DINNER

RECONNECTING COMPASSION AND CHARITY

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AUCKLAND
15 AUGUST 1998

RECONNECTING COMPASSION AND CHARITY

Interviewing Sister Connie Driscoll on the radio during her visit to New Zealand in March 1997, Brian Edwards expressed the opinion that charity was 'offensive'. I was gobsmacked by his attitude and have been pondering it ever since. Sister Connie is a person who is as close to a saint as I expect to meet in this life, and the story of her work for drug-addicted welfare mothers in Chicago inspired her New Zealand audiences, including ACT's annual conference. What kind of person, I wondered, could regard such charity as 'offensive'. Not, of course, that Brian Edwards was against the provision of welfare, but he thought it was the responsibility of government, rather than voluntary charities, to provide it.

It is doubly puzzling to discover such an attitude towards charity when compassion is often elevated to the highest of modern virtues. Is there not something ironic here that needs to be explained? Since compassion – literally, 'suffering with' someone – would seem to lead so naturally to spontaneous charitable action to relieve the suffering, how does the one come to be praised and the other disparaged?

Could the answer be that charity is indeed, as Brian Edwards claimed, 'capricious' and 'unreliable', and that state welfare does the job better? This came to be believed around the turn of the century, when New Zealand and Australia led the world in imitating the state-run social insurance policies that had been pioneered in Germany in the 1880s under Bismarck. The continuous expansion of the welfare state since then has reflected the widespread conviction that welfare is above all a state responsibility, and nowadays is the main justification for high levels of taxation. Whereas in previous centuries the state played a minor role and left most welfare delivery to voluntary mechanisms like families and charity, in the twentieth century that relationship has become inverted: the charities have been relegated to a minor role, and even that is largely supervised and subsidised by the state.

So residual has the voluntary sector become in the way we think about welfare in New Zealand that no reliable statistics about it exist. According to Jim Datson, the immediate past president of the Fundraising Institute of New Zealand, the National System of Accounts puts the value of the voluntary sector in 1993 for gross domestic product (GDP) purposes at $771 million, but the New Zealand Association of Philanthropic Trusts estimates its true value at around $2 billion. The Inland Revenue Department calculates that 'gifted income' amounted to $259 million in 1993. Census figures suggest that New Zealanders volunteer around 500,000 hours of work a year to the voluntary sector. But these figures are very broad-brush, and the term 'voluntary sector' includes many associations, like sports clubs and political parties, that are not charities. The major charities could consider commissioning a proper statistical database of the voluntary welfare sector as a way of raising their profile. Meanwhile we should bear in mind that the charities' incomes are derived not only from gifts but also from government subsidies worth about $580 million a year, commercial activities and accumulated resources.

More accurate information about the voluntary welfare sector is especially needed as confidence in the welfare state declines. In New Zealand, the share of working-age people dependent on state welfare has doubled since 1985 and now stands at one-fifth. Over half of all working-age welfare-state beneficiaries have been receiving their current benefits for more than a year. This rise in welfare dependency continued despite the rise in employment and fall in unemployment in the mid-1990s. Recent publications by the New Zealand Business Roundtable have argued that state welfare has created perverse incentives to become dependent on welfare – to become 'pauperised', in the unsqueamish terminology of previous centuries – and that voluntary associations are more likely to dispense welfare in a way that encourages its beneficiaries to become self-supporting. What is needed is a new division of labour between the state and the wider civil society: the state's comparative advantage is in providing a safety net of last resort, while income security and general personal welfare are in normal circumstances best safeguarded by mechanisms such as private insurance and savings, by family responsibility and by the voluntary sector. The effectiveness of all these mechanisms would be improved if disposable incomes were increased by tax reductions.

In this address I do not wish to rehearse these arguments, beyond commending to you the publications in which they are set out. What I want to do here is to explore Brian Edwards's claim that charity is 'offensive' and the implications of that claim. I believe that the resistance to modern arguments for welfare reform stems largely from a conviction that charity undermines true compassion with unworthy sentiments: that it induces a patronising contempt in the donor, and puts the recipient in a position of humiliating dependency. The welfare state, in contrast, is believed to avoid these effects because it somehow confirms the bonds between donor and recipient as members of the wider community, and distributes benefits without drawing a moral distinction between the 'deserving' and the 'undeserving'.

The most compelling and influential attempt to characterise state welfare as the embodiment of compassion was made by Richard Titmuss, a British academic at the London School of Economics whose work provided one of the intellectual foundations of the postwar expansion of Britain's welfare state programmes. I shall refer to Titmuss several times, not just because of his profound influence, but because the flaws in his arguments are so instructive. His famous 1971 book *The Gift Relationship* grew out of a debate in the 1960s about voluntary donations of blood in Britain. Hospital stocks of blood were always in short supply, and some policy makers were advocating a market in blood, such as existed in several other countries, to ensure that the supply of blood for medical purposes matched the demand for it. Titmuss strenuously opposed this proposal, on the grounds that it would replace the 'gift relationship' that existed between voluntary donors and recipients with the 'exchange relationship' of the marketplace. To the objection that a market in blood might save lives, Titmuss replied that altruistic behaviour was imitative and, if encouraged, would spread by force of example and ensure that sufficient supplies of blood were forthcoming.

But why exactly was the 'gift relationship' so morally preferable to the exchange relationship? Titmuss valued giving blood because it was, he said, a perfectly altruistic unilateral transfer to a stranger, motivated neither by expectation of reciprocal reward nor by favouritism towards its unknown recipient. The impersonal nature and anonymity of the gift relationship between donor and recipient relieved them of feelings of moral superiority and moral inferiority respectively. For Titmuss, this is what the welfare state was all about: it was a moral project because it bound citizens together as moral equals in the gift relationship. It realised the old socialist vision in which people worked not for personal gain but for the collective good: "from each according to his abilities, to each according to his needs".

This argument for the welfare state is what commentators have in mind when they say that the level of welfare state spending is a measure of a society's compassion. It sits rather awkwardly with another popular argument for the welfare state, namely, that we all have entitlements to certain welfare services. For if we have rights to welfare, these must be satisfied as a matter of strict obligation, not altruism. As well, some modern communitarians would object to Titmuss's stress on the anonymity and impersonal nature of the welfare state, since they regard these as undesirable features of the marketplace. Still, I think Titmuss was right to identify altruism as one of the motives underpinning state welfare, because there is widespread support for the view that the state should ensure that no one falls below a certain minimum of welfare. But this is not to say that other motives are absent from the welfare state, or that there is popular support for keeping people in quasi-permanent dependency as opposed to requiring of them some effort to improve their condition.

The real problem with Titmuss's analysis is that it takes absolutely no account of the actual outcomes of the welfare state. Instead of smoothly turning compassionate motives into intended outcomes, the welfare state has produced a state of affairs that no truly compassionate observer could desire. I have already referred to the growing problem of welfare dependency caused by state-administered programmes of unconditional poverty relief. Another problem is the diversion of a huge share of the welfare budget to the non-poor, especially in the form of universal services in health care, superannuation and education. Much of the additional $5 billion of public spending introduced by the coalition government in New Zealand is going to finance services from which middle-class people are the main beneficiaries. This can hardly be described as a manifestation of compassion: rather, it is the outcome of political processes that reward influential lobbies acting in their own interests and without any necessary regard to the public interest. As well, the growing welfare state has contributed to a weakening of the family and of individual responsibility.

In view of these disappointing outcomes of the welfare state, isn't it time we started to question what all this compassion talk is really about? There is the strongest contrast between modern public avowals of compassion and the spirit of practical concern that sustained the many vigorous voluntary welfare associations that flourished in the late nineteenth century and that Titmuss hoped would sustain the welfare state that has largely supplanted them. Very often nowadays, 'compassion' seems to consist of the expression of publicly virtuous sentiments in the media or the pulpit, but little in the way of genuine giving or personal commitment. Several critics of the welfare state have drawn attention to this stress on the feeling of compassion at the expense of concrete assistance for the object of the compassion. Robert Whelan, for example, writing in *The Corrosion of Charity: From Moral Renewal to Contract Culture*, gives this account of what he calls "compassion without tears":

> The politicisation of welfare has a certain obvious appeal. … The measure of good citizenship used to be the extent to which men and women of goodwill would give of their own time and resources to address social problems. Now, all that is required is political lobbying. … Instead of putting your hand in your own pocket, you can feel virtuous by demanding higher taxes to finance increased public expenditure – which is effectively putting your hand in other people's pockets.

In similar vein, Marvin Olasky, in *The Tragedy of American Compassion*, observes that 'compassion' has become a double-think term to mask the fact that the welfare state promotes personal meanness:

> We celebrate America as a compassionate, caring society. But most of us are actually stingy – not because we refuse to spend more government money (we're actually doing quite well there, thank you), but because we no longer offer the poor our time and a challenge. Our willingness to do so shows whether we care for hearts, minds, and souls, or just bodies – and, as a society, we fail the test.

Indeed, the welfare state now embodies some of the features of charity that Brian Edwards appears to find offensive. At its worst, charity was an aristocratic pastime in which ladies bountiful derived a sense of moral superiority from dispensing amounts they could easily afford to the lower orders as a way of keeping them content with their humble lot. Similarly, the welfare state has generated a class of dependants whom its intellectual supporters patronise by telling them they are 'victims of society' while arrogating to themselves the kudos of the system's presumed virtuousness. Just as the ladies bountiful resisted the political reforms that emancipated their serfs, so welfarist intellectuals resist the economic and social reforms that would restore to citizens control over their own incomes and responsibility for their own lives. In this context it is regrettable that many in the churches, whose intentions in this area are generally sincere and honourable, should have come to support so strongly the delegation of compassion to the state. This may be one of the reasons why their status as a serious moral force in society is so much diminished.

The truth is that the link between compassion and the welfare state, if it ever existed, has been largely shattered by perverse incentives and political opportunism. If we really want a truly caring society on the one hand, and a welfare system that works on the other, we must rethink from scratch the relationship between the two, and try to see where charity really fits in.

Recall the contrast that Titmuss drew between the gift relationship and the exchange relationship. Titmuss was assuming, as nearly everyone does, that gifts, being based on altruism, are morally superior to exchanges, that are allegedly based on self-interest. This simple-minded contrast is misleading and inaccurate in so many ways. In the first place, more welfare is generated by exchanges than by gifts. This is part of the general point that any wealth given away must first be produced. Both parties to a voluntary exchange benefit from it: it increases wealth. In a modern economy, the greater part of welfare is necessarily generated by spontaneous commercial exchanges among people whose labour is divided and specialised in their search for comparative advantage. Of course, gifts also promote welfare. In some areas, gifts may create as much welfare as do exchanges; it may well be possible, as Titmuss hoped, to secure a sufficient supply of medical blood by voluntary donations. But where it isn't possible, it is surely immoral to risk lives by prohibiting a market in blood in order to preserve the purity of the 'gift relationship'. When it comes to welfare, it is consequences that count, not motivation.

Again, the contrast between altruism and self-interest can be overdrawn since, in reality, the two motives are often mixed. First, there is a sense in which a pure gift benefits the giver as well as the receiver. This point was made by Shakespeare in *The Merchant of Venice*: in Portia's famous soliloquy on 'the quality of mercy', she says:

> It is twice blest,
> It blesseth him that gives and him that takes.

In a more pedestrian mode, an economist might notice the analogy between gifts and exchanges: just as both parties to a voluntary exchange gain from it, so a voluntary gift benefits the giver in the sense that they prefer to see the money, or whatever the gift consists of, in the recipient's hands rather than in their own. Yet this does not detract from the meaning of the gift; indeed, the spirit of giving is precisely one of wholehearted goodwill, and is spoiled if the gift is made reluctantly or resentfully.

This point brings into view yet another problem with Titmuss's ideal of a welfare state built on the gift relationship. In what sense can transfers financed by compulsory taxation be understood as 'gifts'? The idea is not wholly preposterous; I have already suggested that there is an altruistic consensus for a welfare safety net financed by taxation. But that would require a much smaller tax burden than our actual welfare state imposes. In practice, taxes are typically paid without goodwill, and are experienced as a loss rather than a gain. I say this knowing that some opinion polls purport to show that many New Zealanders are willing to pay more taxes to finance more welfare spending. The point is that their behaviour just doesn't bear this out. Who volunteers to pay more tax than they are legally obliged to? There is nothing to stop people sending additional cheques to the Inland Revenue Department or to the Department of Social Welfare, but how many people do? How often do voters reward a political party that promises to increase their taxes? I suggest these actions speak louder than words. Those who want to make society more compassionate are going to have to encourage more voluntary giving, which implies a cut in taxation and state welfare, not more of it.

The second way in which the altruistic and self-regarding motives are mixed is evident in long-term relationships in which welfare-enhancing exchanges occur that are not commercial ones but nevertheless benefit both parties. Consider ordinary friendships. Friendships are sustained by giving; if one party offered to pay for a gift, thus turning it into a commercial exchange, the friendship would be ended or damaged. But if over time the giving were all one way, that would usually threaten the friendship too. The long-term relationships on which we all depend are sustained by giving, but also by a principle of *mutuality* or *reciprocity* that ensures that both parties share the burdens and benefits.

Brian Edwards, like Richard Titmuss, appears to conceive direct personal charity as a wholly one-way relationship that is offensive because it places the receiver in a condition of humiliating dependency. But I suggest that this view overlooks the quiet but huge role that practical, reciprocal charity plays in our lives. In a myriad of ways, in all spheres of our lives, we are constantly giving and receiving aid in a mutual fashion. We understand that elementary cooperative, respectful and considerate behaviour is necessary if we are to realise our individual or collective goals. This sort of mutuality doesn't require any precise equality in the value of the services exchanged, as purely commercial exchanges might, but it does make us morally equal members of the wider communities in which we participate.

The principle of reciprocity is being invoked in the movement for welfare reform that is getting under way in several countries. In the United States, the welfare reform of 1996 obliges recipients of state welfare to undertake training or employment where they can. In Australia, the work-for-the-dole scheme requires young people receiving the unemployment benefit to do the same. The community wage proposal has a similar motivation. The public is demanding that the people they are willing to help through their taxes make the effort to become self-supporting. Yet these state schemes are only imitating the way that voluntary associations have been operating for decades, even centuries. Marvin Olasky shows in *The Tragedy of American Compassion* that the voluntary associations that thrived before the rise of state welfare, and even after it, always made the avoidance of pauperism one of their highest priorities. As Sister Connie Driscoll explained to Brian Edwards, the homeless and destitute young women who enter her hostel have to agree to abide by certain standards of conduct and to help run the place, and can't expect just to be passively clothed, fed and sheltered.

One of the reasons why the voluntary sector is generally better placed than state bureaucracies to administer assistance in a way that helps recipients to recover their independence and self-respect is that it need not be inhibited about moral education. There is a case for believing that just as state education should not promote religious belief, so state welfare should not impose any moral code beyond elementary honesty and the minimal obligations of reciprocity that taxpayers may demand. But voluntary associations are surely entitled to try to impart the moral beliefs of their supporters to those they assist. Competition among the voluntary associations would reveal which codes of behaviour are most effective.

In an age dominated by an uneasy combination of two elite intellectual fashions, moral relativism and political correctness (and paradoxically, the two contradict one another), it is difficult to say in public, for example, that teenagers should not have children outside marriage, or that, if they do, that they should get married and stay together so as to give their child the best chance in life. But in a thriving voluntary sector, each association would have every incentive to broadcast the values it promoted, and the results obtained from them, as a way of attracting donations from the public. Meanwhile, those who wished to receive assistance would be able to exercise a certain degree of choice over the terms and conditions that came with it. The churches have an obvious role to play in this respect – if only they could see it.

The principle of reciprocity is popular because it unites giver and receiver in a mutually satisfying relationship in which the former can see the beneficial outcome of assistance, while the latter can derive a sense of achievement and self-confidence from meeting the standard of conduct expected. There is an infinite variety of ways in which reciprocity can be institutionalised. Here I would like to canvass just one particularly promising form of voluntary assistance, namely, microfinance, or the lending of small amounts of capital outside the formal commercial sector. This was pioneered as a means of development aid in 1976 by the Grameen Bank of Bangladesh. It consists of lending small amounts of capital to people who are too poor to interest the commercial banks, and relying on peer pressure from groups of loan recipients to ensure repayment. A woman might be lent as little as US$50 to buy, for example, a sewing machine and set up a microbusiness from which the loan is repaid. Amazingly, the repayment rate is higher than that for ordinary commercial loans. Eventually, many such people become wealthy enough to deal with the commercial banks, while the loans they have repaid with interest are lent to other people at the lower end of the income ladder.

One of the most active proponents of the microfinance movement is New Zealand-born David Bussau, who in 1979 set up Opportunity International after witnessing the failure of government-to-government aid programmes to help the poor after an earthquake in Bali. He sold his businesses and spent the next five years organising microenterprise programmes in Indonesia. Now, the Opportunity International network, based in Sydney, has over $30 million invested in over 100,000 jobs in 27 countries. It receives donations from the public, and governments are starting to channel their development aid through it and similar organisations in recognition of its success. It remains little known, but whenever it is publicised it attracts many inquiries from members of the public who are willing to make donations but want some assurance that the money will be well spent. The principle of using the money not as simple handouts but as loans that will be repaid and used over and over again is immensely appealing and needs no elaborate advertising to promote it.

Microfinance has also been pioneered in New Zealand as a form of domestic voluntary assistance. Kingdom Resources is a Christian non-profit organisation that helps low-income households in Christchurch and North Canterbury that are in financial difficulty. It offers them budgeting advice and if necessary reschedules their debts with interest-free loans; it also offers them a three-week course that aims to raise their members' self-confidence, trains them in managing their incomes, and helps them find employment. Members of the public can help in a variety of ways, not just by giving money but also by investing it in non-interest-bearing fixed-term or on-call savings accounts. Businesses can open accounts that take their monthly cash flows or set aside money for provisional tax. Kingdom Resources has 136 volunteer budget advisers and in 1996 advised a total of 592 clients.

These microfinance experiments show that assistance can be given in ways that break down the simple-minded categorical distinctions that so hamper our thinking about voluntary welfare. The initial distinction between givers and receivers becomes dissolved in a network of multilateral mutual aid. Altruism and self-interest are not in conflict but are both harnessed to increase the welfare of all. Reciprocal relationships contain elements of both exchanges and gifts. Comprehensive reform of the welfare state would create opportunities not just for the extension of assistance through microfinance but also for other imaginative and creative forms of charity yet to be devised and tested.

In helping the voluntary sector to do its job and reveal its comparative advantages over state welfare, we need not only to give more resources to it, but also, and more importantly, to pay more attention to the ways in which we give. As Robert Whelan tells us in the book I quoted earlier, most of us could devote more time, if we organised it properly, to directly volunteering our services and becoming active participants in the organisations that we support. The churches and the charities themselves could surely take the lead by spending less time lobbying the government for subsidies or welfare policy changes, and more time informing the public about the amounts and kinds of help that are needed. They could, for example, mount a campaign to persuade New Zealanders to emulate the American practice of giving away, on average, one week's income every year. Philanthrophy in America is not primarily associated with business, contrary to some views in this country: 95 percent of charitable donations in America come from private individuals and foundations. Rather than relying on the government's alleged comparative advantage in raising money, they could call for a return of the days when New Zealand was a truly more caring and charitable society, before the welfare state and high taxation took away much of the incentive and the means to make charitable donations.

In any case, it is far from clear that government has any comparative advantage in raising money for welfare. The administrative, compliance and other deadweight costs of taxation in New Zealand are at least 30c in the dollar: probably higher than the administrative costs of most charities, and certainly much harder to reduce. This is also an argument, incidentally, for helping the charities by means of general tax cuts rather than tax breaks for donations, since the latter imply higher general rates of tax and hence higher deadweight costs.

Just as we can no longer plausibly delegate our philanthropic duties to the state, so we cannot delegate them to 'the rich', whether directly or under the guise of the so-called 'social responsibilities' of corporations. Some of the best-known philanthropic foundations were created in the nineteenth century by people who were less wealthy absolutely but more wealthy relative to the average than anyone is today. As Peter Drucker has pointed out, J P Morgan's fortune at its greatest was about one third of Bill Gates's fortune today, in real terms. But whereas Morgan could finance all America's economic needs (other than residential housing) for four months, Bill Gates could finance America for only about two days. Just as the mass of middle income earners pay the lion's share of tax revenues, so they will have to finance the bulk of any shift from state welfare to private welfare. It really is up to all of us.

To conclude: the problem with much modern charity is not, as Brian Edwards claims, that it is offensive. To view the work of someone like Sister Connie Driscoll in this way is extraordinary. But charity does challenge socialism, a major motive of which has always been power-worship, or an identification with the state, and a corresponding resentment of the spontaneous actions of private individuals that may well undo the state's best-laid plans and reveal their inadequacies. Charity can be unreliable and capricious, as Edwards also said, but that is also true of state welfare, and probably more so. Certainly, charity can, like state welfare, thoughtlessly perpetuate dependency by merely relieving symptoms. Marvin Olasky tells in his book how he discovered this by pretending to be homeless. In March 1990 he dressed himself in the appropriate ragged attire and began to shuffle slowly around the streets. What happened?

> In two days I was given lots of food, lots of pills of various kinds, and lots of offers of clothing and shelter. I was never asked to do anything, not even remove my tray after eating. But there was one thing I did not get, even though I asked for it many times: a Bible.

If compassion is to be something other than a matter of self-congratulation, and charity more effective than immediate and impulsive redistribution, there is no alternative but to think harder about what we are doing. The American social historian Gertrude Himmelfarb has put it in a way that aptly sums up much that I have been saying:

> Charity is, or should be the exercise of "a thoughtful benevolence". Not benevolence alone but a thoughtful benevolence – a reasoned, prudent, discriminating, even sceptical benevolence – a benevolence that is acutely aware of the often unintended consequences of goodwill, that knows that it is more important to do good than to feel good, that it is morally and spiritually satisfying for the giver, and morally as well as materially beneficial to the receiver. It is the kind of charity that promotes welfare in the proper sense of that word – the well-being of the citizenry.

ASSOCIATION OF SUPERANNUATION FUNDS
OF NEW ZEALAND (ASFONZ) 1998 CONFERENCE

FROM ENTITLEMENT TO NEEDS: ABANDONING NEW ZEALAND'S LAST THINK BIG SCHEME

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NEW ZEALAND BUSINESS ROUNDTABLE

CHRISTCHURCH
9 AUGUST 1998

FROM ENTITLEMENTS TO NEEDS: ABANDONING NEW ZEALAND'S LAST THINK BIG SCHEME

1 Introduction

Over the life of the coalition government there have been four major events in the superannuation debate. First, a referendum on the retirement savings scheme (RSS) was held in September 1997. Secondly, the 1997 Periodic Report Group (PRG) submitted its two reports on the five-yearly review of the retirement income policy framework. Thirdly, the government abolished the superannuation surcharge from 1 April 1998. Finally, the Investment Savings and Insurance Association (ISI) issued in June its report on retirement savings, *A Wake-up Call*. As a further development, the level of commitment to the 1993 Accord on Retirement Income Policies (the Accord) appears to have weakened.

On the face of it, recent events could suggest that superannuation policy is in some disarray. A more detached view suggests this is not necessarily the case.

2 What has been established?

The most important point on which there is now wide agreement is the one that the New Zealand Business Roundtable has emphasised all along, namely, the central importance of economic growth. The need to improve the economy's growth performance is the main message of the ISI report. It provides a good platform from which to move forward.

The ISI observed that the conclusions that flow from its research "seem stark and obvious". The report argues that it is necessary to raise the rate of economic growth, remove impediments to savings and investment, and limit government spending. It states that these policy areas need to be addressed "without delay". The view of the PRG that adjustment could be delayed was correctly judged to be too complacent. Overall community welfare, including that of future retirees, is best safeguarded by addressing superannuation arrangements earlier rather than later. In keeping with this view, the Organisation for Economic Cooperation and Development (OECD) has advised member governments to take action now to maintain prosperity in an aging society.

The ISI recognises that the material living standards of future retirees will largely depend on the volume of goods and services produced by those in employment. People cannot eat dollar notes in their retirement. They must be able to exercise claims over real goods and services. The retired elderly are ultimately dependent on a productive economy to meet their material needs.

In the past few months the International Monetary Fund (IMF), the OECD and credit agencies have all commented adversely on New Zealand's economic performance. The IMF noted that growth has slowed, the structural fiscal surplus has been reduced, private saving is low, competitiveness has deteriorated and the large current account deficit makes New Zealand vulnerable to external shocks such as the crisis in Asia. Business organisations have been making the same points.

Since the mid-1990s New Zealand has not maintained an active growth strategy. The annual rate of growth has been slowing since 1995 and this year may see a standstill. We are not within sight of achieving the goals of 3.5–5 percent growth (National) and 6 percent (New Zealand First) targeted by the coalition partners. This performance bodes ill for future living standards, including those of the elderly.

The most important step the government could take to advance the income security of all New Zealanders would be to reactivate a bold growth strategy. The major policy errors since the mid-1990s have been the blowout in government spending and the virtual standstill on microeconomic reform. The Mixed Member Proportional electoral system (MMP) has compounded the problem. We are seeing a string of low-quality decisions such as the Clayton's package of $300 million of spending cuts, the draconian interventions in the electricity market, the backward moves on the Auckland Regional Services Trust and the failure to reform labour legislation, to name just four in the last two months. The backdown on employment law will mean unemployment will continue to rise. The recent OECD report on New Zealand noted that we are no longer on a path of convergence with higher income OECD countries. Living standards for all age groups will be unsatisfactory if policies are not adjusted in ways consistent with the ISI's emphasis on enhancing growth.

The second point that has been established is that a compulsory savings scheme is not a credible policy option. The argument over the RSS was not about public versus private provision. The underlying premise was that private provision should increasingly be the norm and the issue was whether it should be compulsory or voluntary. That argument has been settled, at least for the foreseeable future.

The third premise of future debate is that income tax concessions for retirement savings are also off the agenda. The argument for concessions has been examined on many occasions over the last decade and it has never withstood close scrutiny. The Todd Task Force, the parties to the Accord and the PRG all concluded against tax concessions. The research commissioned by the ISI also noted the importance of neutral tax arrangements. The report stated that "If investment funds are flowing into particular areas because of tax or regulatory reasons ... then overall returns [to the community] are lowered". Tax concessions for retirement savings are incompatible with a sound growth strategy.

However, it is most certainly the case that taxes, particularly income taxes, discourage savings. The best way to address this problem is to keep government spending, and hence the tax burden, low. The recent loss of fiscal discipline must be reversed. Much current spending is poorly targeted and of low quality. Given sound overall economic management and robust growth, the ratio of government spending to gross domestic product (GDP) could be reduced to under 20 percent over the next 5–10 years. Government spending is the true tax burden, and such a reduction would constitute a large tax cut. There is no doubt that the current tax burden in New Zealand creates an environment that is hostile to savings.

There are grounds for placing greater weight on goods and services tax (GST) relative to income tax. An income tax distorts the choice between present consumption and saving. People are discouraged from saving for their retirement because of the cumulative impact of income tax on salaries and wages and on the returns from what they save. In contrast, GST treats current consumption and savings on the same basis. Moreover, a broad-based consumption tax like GST generally treats savings and investment uniformly whereas tax concessions favour particular classes of savings, investment products and institutions.

As government spending is lowered, income tax rates should be reduced faster than the rate of GST. The income tax scale should also be flattened by reducing the top personal and company rates of tax. The deadweight cost of taxes increases more than proportionately as marginal rates of tax increase. A more uniform tax scale would avoid complexities like the Taxation of Life Insurance and Superannuation (TOLIS) proposals and provide wider efficiency benefits.

In addition to these specific areas of progress in the superannuation debate, community attitudes and most aspects of policy towards retirement incomes have been moving in the right direction for some years. There is now broader acceptance that, for the majority of people, retirement income should be a personal responsibility, not a taxpayer one. This acceptance is likely to grow: young people appear to look less to the government to provide them with a living than their parents have typically done. The cost of New Zealand Superannuation (NZS) has been reduced by raising the age of eligibility and lowering its level relative to wages. The Accord provided a more predictable policy environment.

The removal of the surcharge is the exception to this trend. Many commentators have, however, recognised that its abolition was unwise. The Christchurch *Press* observed in an editorial that the coalition government's search for $300 million of expenditure savings could be achieved in one stroke if the surcharge were restored. It noted that only 16 percent of superannuitants were affected by the surcharge and they were all earning annual incomes of over $45,000 (single) and $75,000 (married). *The Press* wrote that: "Although not popular, the surcharge was accepted by many in the community as fair". Some ministers have also acknowledged that NZS should in future be means-tested.

3 What is left to be addressed?

With the primacy of economic growth established and compulsion and tax concessions sidelined, the way has been cleared to 'make super simple'. The key outstanding issue to be resolved is the design of the safety net.

This issue is usually discussed in terms of the level and qualifying age for NZS and whether it should be provided on a universal or targeted basis. However, behind that choice is a deeper argument: whether superannuation is a matter of entitlement or needs. Grey Power views superannuation as an entitlement and, as such, it argues that it should be universal. All recent reviews – the 1988 Royal Commission on Social Policy, the Todd Task Force, the PRG and the ISI's report – view superannuation as needs-related and part of the general welfare system.

Several arguments have been advanced for an entitlement approach to superannuation and benefits. One is that welfare should be provided on a universal basis as a badge or right of citizenship. Another is that a universal entitlement should be given to citizens to avoid stigma, to compensate victims of misfortune and to enable people to achieve the level of consumption required to participate in society. Means testing is not always rejected by those who endorse citizenship theory. The 1972 McCarthy Royal Commission on Social Security, for instance, adopted a citizenship perspective in discussing benefit levels but endorsed the continuation of income tests.

In his book *From Welfare State to Civil Society*, David Green argues that universalism intensifies the corruption of vote-buying and middle class subsidies. "Where," he asks, "is the concern for social solidarity in telling people that they can enjoy many benefits at the general expense?" According to Green, a notion of universal entitlements "breeds division and antagonism" rather than social cohesion. Moreover, an appeal to citizenship and the assertion of rights to welfare do not take us far in establishing sound policies. They are of little help, for instance, in deciding in what circumstances people should be supported by taxpayers, who should be supported, to what level and on what basis.

A large proportion of the tax revenue that is raised to finance universal entitlements is returned to the same taxpayers in the current period or at a later time. This income 'churning' results in high levels of tax with associated deadweight costs that reduce economic growth. For this reason, needs-based support is usually preferred on the grounds that it is least harmful to the economy. Moreover, the transfer of income from people on low and moderate incomes to those who are well off is inequitable.

A needs-based approach to superannuation is the historical norm in New Zealand. The legislation that introduced the old age pension almost exactly 100 years ago was tightly drawn and few received assistance. Applicants for a pension had to satisfy numerous requirements. They had to be at least 65 years of age – a high qualifying age relative to life expectancy at that time – and to possess little or no property or other income. By 1940 only half of all people who satisfied the age criterion qualified for a pension.

The age of eligibility for the age benefit, which replaced the old age pension, was set at 60 for men and women on the introduction of the social security system in the late 1930s. The level of the benefit was increased but it remained modest. In 1945, for instance, the weekly age benefit was equivalent to a day and a half of a labourer's pay and was broadly equal to the family benefit paid to a mother of three children. The means test was retained. It included an asset test that was not abolished until 1960.

Only three-quarters of all elderly people qualified for a state pension of any sort in 1950. A modest universal superannuation scheme had been introduced in 1940. It was intended over many years to replace the age benefit with a non-means-tested and taxable payment for residents over 65 years of age. In the meantime universal superannuation was to run alongside the age benefit. The age benefit, in effect, was to become universal at age 65. However, it was not until 1960 that the rate of universal superannuation reached that of the age benefit. Even then, the age benefit was tax free whereas universal superannuation was taxable. With a highly progressive tax structure and a top income tax rate of 60 percent, taxable universal superannuation was in some ways like a targeted supplement to the age benefit.

After the short-lived funded scheme introduced by the third Labour government, the character of New Zealand's safety net was dramatically changed for the worse by the introduction of National Superannuation in 1977. National Superannuation was an unfunded, non-contributory, universal scheme payable at age 60. It was set at a much higher level than the former age benefit. The generosity of the scheme and an increase in the proportion of superannuitants in the population eventually led to the introduction of the surcharge and to other measures to contain its cost.

This quick historical tour indicates that the long-run tradition in New Zealand has been to view income security in retirement as part of the general safety net. Unlike the approach of many other countries, benefits have always been flat-rate rather than income-related and with the brief 1970s exception, schemes have been non-contributory. Moreover, for most of this century means testing has been an integral part of New Zealand's support for the elderly and other welfare arrangements.

It is often asserted that the retired have paid for NZS through their past taxes. Grey Power, for instance, recently argued that "New Zealand's senior citizens have paid their dues" and that "3.7 billion dollars was ripped away from retired New Zealanders during the life of the surcharge". These claims are utter nonsense and their barefaced repetition should be condemned by politicians.

The truth is that successive governments have funded publicly provided superannuation out of current tax revenue, including the short-lived social security charge and tax. They have been pay-as-you-go schemes. An investment fund to finance future public pensions has never been established.

As far back as the 1967 Ross Committee and the 1972 McCarthy Royal Commission, official inquiries were pointing out that annual social security contributions were falling well short of the level needed to fund current pensions and other social security benefits, and they were subsequently scrapped. The McCarthy Commission, for example, stated that:

> … although a special Social Security Fund was established to receive the 5 percent (later 7.5 percent) contribution (or social security tax), this fund was never actuarially funded according to private insurance principles and was never sufficient to meet the total cost of the scheme. It was thus not a true insurance scheme. The basic principle was that people should contribute according to their means and receive benefits according to their needs and not in relation to the amount of their contribution.

There is nothing wrong with funding a safety net out of current tax revenues, but the idea that NZS is something different – more like an entitlement – is an illusion.

In his book *Selfish Generations*, David Thomson of Massey University has examined whether the welfare benefits that the present generation of retirees will receive over their lives will be matched by the taxes that they pay. The former are broadly defined to include social security cash allowances, education, housing, health and other government services. While such calculations raise difficult conceptual and measurement issues, I am not aware of any major challenge to Professor Thomson's general findings. These are that the older generations in New Zealand systematically benefited at the expense of those that came later. He finds, for instance, that the average ratio of lifetime welfare benefits to taxes for a person born in 1930 will be almost 1.8 to 1.

By contrast with an entitlement approach, a needs-based approach to a safety net emphasises individual responsibility. The role of the government is to help people who cannot help themselves and who cannot be supported in other ways. A needs-based approach is generally more equitable and efficient than an entitlement approach because people on low to modest incomes are not taxed to increase the incomes of retired millionaires. In the case of the next group, the broad category of middle-income earners, a non-targeted benefit results in the government taxing one group of people only to return the money to people in a similar category, with all the compliance, administration and deadweight costs associated with such 'churning'. A strong argument can be made that it is only the category of low-income earners or those without resources who should be the object of public policy, on either efficiency or equity grounds, through targeted assistance.

Viewed in safety net terms, it is hard to see how the government's welfare responsibility for people in old age differs from its role in respect of those facing other lifetime contingencies, namely to protect people from hardship. Families are normally expected to be responsible for providing for their own incomes, and the role of the government is limited to providing an adequate income to those without other means in the event of sickness, invalidity or unemployment.

The basic dilemma in designing a safety net is easily stated. Besides its other limitations, a universal scheme is very costly, it imposes a high tax burden and is a drag on growth. Its perceived advantage from a savings perspective is that it avoids the problem of a high effective marginal tax rate on retirees' other income that can arise with targeting – the so-called 'savings disincentive'. This effect, however, is likely to be outweighed by the higher tax rates and greater disincentive to savings associated with an expensive universal scheme that apply to the whole population of taxpayers. Conversely, a targeted scheme imposes a lesser fiscal burden and is less harmful to economic growth. The best way of avoiding excessive marginal tax rates with a targeted scheme is to get overall tax requirements down, to set the benefit at an appropriate level, and to begin phasing it out at a realistic threshold.

The PRG headed in the direction of a needs-based approach. In its interim report, which is to be read alongside its final report, the PRG stated that it supported targeting and regretted the "impending abolition of the surcharge". In its final report it suggested five options that essentially boil down to three: a universal benefit, a part-universal/part-targeted benefit, and a targeted (income- and asset-tested) benefit. There are no sound efficiency or equity grounds for a universal benefit, and the fiscal costs and deadweight losses associated with such a scheme are large. Given that conclusion, it follows that part-universal and part-targeted options make no sense either.

With proper political leadership, I believe there is a good prospect of achieving a public consensus around the idea of a needs-based safety net just as there is solid public support for a state role of last resort in other welfare settings. There are sound equity arguments for such a role. Most people are happy to help people who need help, but are not keen on seeing their taxes going to those who do not. Equity and efficiency arguments for other approaches, such as those involving universal payments, are weak and stand little chance of being politically sustainable over the long run. There may be a case for limiting the impact of targeting on those in or near retirement, but new cohorts of retirees should be given a clear signal about the basis on which they should make their retirement plans.

4 Conclusion

The resolution of the choice between an entitlement- and a needs-based approach to the design of a safety net is the main outstanding issue in retirement income policy. The ISI is pointing in a needs direction – it has said that the issue will be part of the next stage of its work. Universality is essentially another of New Zealand's unfortunate Muldoonist legacies – another 'Think Big' scheme. Like the others, it should be abandoned; its new lease of life this year will hopefully be brief.

The surcharge was not the best way of re-establishing a needs-based approach. The Labour government adopted the surcharge as a roundabout way of avoiding breaking the letter of its election promises. National also broke an election promise on the issue. The political costs that have been paid for not confronting the issue up-front have been heavy. It is time we had the maturity to approach targeting directly. A sound safety net should be designed that has regard to factors such as the qualifying age, the levels of NZS, income abatement rates and asset tests. Australia has achieved a political consensus on an income- and asset-tested safety net and there is no reason why New Zealand could not do likewise. Doing the necessary analytical work and promoting such a consensus should be a priority for the ISI, Association of Superannuation Funds of New Zealand (ASFONZ) and other interested parties.

MISCELLANEOUS

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INTERNATIONAL CONFERENCE

THE CHANGING FACE OF BUSINESS

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THE CHANGING FACE OF BUSINESS

At the end of the twentieth century, it seems natural to adopt a broad sweep and to consider how the face of business has changed over the past one hundred years. It goes without saying that it has changed, in some ways radically so. But it's worth stressing at the outset that business today is recovering some of the characteristics that it lost during the present century.

The most obvious of these characteristics is its international dimension. Nowadays, this is often referred to as 'globalisation', as if this were some wholly new phenomenon. In reality, the present internationalisation of business has been building up ever since World War II, in reaction against the protectionism that preceded that war and helped to cause it. Almost everywhere, governments, to varying degrees, have liberalised trade in goods and services and controls on capital flows, and in some cases have eased restrictions on movements of people as well. Moreover, modern 'globalisation' has yet to re-establish the degree of international integration that was achieved by the end of the nineteenth century, the century in which the ideas of Adam Smith about free markets and free trade were most fully reflected in public policy, especially in Britain. From this perspective, the twentieth century looks like a long detour for business, during which governments lost their way in the protectionist wilderness and, over recent decades, have slowly been getting back on track. It brings to mind a joke that circulated in Hungary under communism: "Question: What is socialism? Answer: The longest and most painful road from capitalism to capitalism".

During that detour, the face of business – or the free enterprise system – acquired several scars which, though fading, are still evident. One hundred years ago a much larger share of the population was employed in the private sector than today. Then, government commanded only about 10 percent of the economy. During the twentieth century, and until very recently, government spending has absorbed a higher and higher fraction of national income, not just in communist countries but in the Western democracies as well. There, it has sometimes gone as high as 60 percent of the economy; in New Zealand it is around 40 percent. After trending downwards in the early 1990s the government spending ratio in New Zealand will have risen again for four successive years by the coming financial year, according to the government's projections. Yet even these massive levels of government spending underestimate the impact of government on society, which is exercised not only through spending and taxation but also through regulation and ownership. However, although state ownership is going out of fashion everywhere, although more slowly in New Zealand than in many other countries, regulation is not, and is even increasing.

This rise of the state throughout the twentieth century was accompanied by a number of anti-business – or at least anti-market – doctrines that were to become extremely influential among intellectuals and the framers of public opinion generally. Although these doctrines are largely discredited today, they retain a powerful hold on the imagination and prejudices of academia, the media, and sections of the general public. Their influence is evident in the constant invasions by governments and courts into property rights and contracts freely entered into by responsible individuals. Organisations like the New Zealand Business Roundtable find themselves obliged to carry on a constant campaign to refute them in their many and recurring guises.

Several factors contributed to this shift of opinion against the market. By the end of the nineteenth century, the industrial revolution had quadrupled average wages in Britain and lifted the mass of the population from centuries-old poverty. Yet – as is the case, for example, in China today – material progress is never uniform, and the mythology of an impoverished factory proletariat and a rapacious and increasingly prosperous capitalist class also became firmly established in Britain, propagated in literature (especially certain novels by Charles Dickens) and in socialist propaganda. The counterpart myth in the United States was the alleged emergence of a class of so-called 'robber barons' who became fabulously wealthy as that country industrialised. Envy-based ideas, such as the fallacious notion that the poor are poor because the rich are rich, have always found responsive audiences. Thus, despite its phenomenal success in raising living standards in the previous one hundred years, the capitalist system ended the century under a cloud. For many people the idea of business lost its primary connotation as the mundane matter of earning one's living in the marketplace, and came to be identified with a dominant social class characterised by wealth and privilege.

The best known intellectual critic of capitalism in the nineteenth century was, of course, Karl Marx. Marx had attacked the classical political economists' idea of the market as a system of voluntary exchanges from which all parties benefited, and substituted his own analysis of the market as a mechanism of class exploitation. Equally influential was his argument that the free market was self-destroying: that competition led to monopoly as larger firms swallowed their rivals or drove them out of business. Among Marxist true believers, this was an indispensable part of the doctrine of the historical inevitability of the demise of capitalism and its replacement by socialism. But the idea was widely accepted also by many non-Marxist intellectuals, including some who were not necessarily hostile to business. Among them, the issue was how to manage the power of the giant corporations that had emerged as a new historical phenomenon. Their answer was *corporatism*: a political system in which corporations negotiated deals and wielded power with the other main social organisations, in particular trade unions and the government itself. The corporatist phase of the history of business, that dominated the middle decades of the twentieth century and was prominent until very recently in New Zealand – Mike Moore, for example, used to talk about "the negotiated economy" – is responsible for many of the current perceptions and misperceptions of business.

The most influential theorist of corporatism, though not necessarily the best known, was the economist Joseph Schumpeter. It is ironic that Schumpeter's best work highlighted the importance of entrepreneurship and innovation in the early phases of capitalism. Schumpeter spoke of the "gales of creative destruction" that the free market unleashed and that generated unprecedented wealth by continuously replacing existing ways of doing things with more productive ones. However, he took the view in his 1942 book *Capitalism, Socialism and Democracy* that the appearance of large corporations in the early twentieth century signalled that the age of the free market and the entrepreneur was over. The modern corporation, so he thought, was not subject to market forces. It was run, he claimed, not by entrepreneurs or shareholders seeking to maximise their profits but by managers with the power to dominate markets unchecked by the forces of competition.

This analysis of modern capitalism had profound implications for public life. Schumpeter put forward corporatism as an alternative to violent socialist revolution that would nevertheless deliver all the benefits of central planning. The state should become a kind of coordinating mechanism by overseeing the investment plans of corporations and, in cooperation with their managers, work to eliminate the business cycle. Meanwhile, it would co-opt the trade union movement and use it to discipline the workforce – Schumpeter made no secret of his admiration for the way that communist regimes had abolished the right to strike (since it so clearly undermined central economic planning) and then imposed official trade unionism on the workers. Such a system could become formally socialist by abolishing private property. However, this was hardly necessary for the success of central planning, since the industrial managers were effectively in control of their corporations regardless of whether these were legally owned by shareholders or by the state, and they could see the benefits of planning as a means of preserving their market shares.

The best-known populariser of corporatism in modern times has been John Kenneth Galbraith. He was better disposed to trade unions than was Schumpeter, seeing them as a necessary 'countervailing power' to corporations. However, he was very successful in spreading the idea of an economy dominated by the producer power of corporations (using means such as advertising) as opposed to the consumer power of the general public. This idea is also propagated by commentators like Noam Chomsky, who is openly hostile to big corporations (though not to big government) and believes that they dominate the media in order to promote notions that reflect their own interests. (He seems not to have noticed that his latest television programme advancing this message amounted to an automatic refutation of it.)

Such ideas – the market superseded by planning, and corporations arranging the world to suit their own interests – have sunk deep into the way many people think about business. The trouble is, they are wrong. Monopoly is one of the most over-emphasised and abused concepts in economics. In the absence of state-conferred protection, the overwhelming majority of large businesses get large because they out-perform others in meeting consumers' needs. They can't get and stay large in competitive markets without consistently delivering value for the goods and services they produce. The trouble arises when governments start granting protection and favours to businesses, and picking and backing industry 'winners' with subsidies. Such policies lead firstly to wealth-destroying interventions such as import licensing and producer boards and ultimately to fiascos such as the 'Think Big' projects of the Muldoon government or Asian-style crony capitalism. Judging by recent government statements about "fostering enterprise", opposition party statements about "industry policies" and *Business Herald* interpretations of Ireland's economic performance, we do not seem to have heard the last of them.

Schumpeter and other corporatists failed to notice that decentralisation of the economy proceeded at the same time as centralisation; as some firms grew or merged to form giant corporations, plenty of small firms were being born as well. We now know that the alleged "separation of ownership and control" of business was another myth; large shareholders have always played an important part in corporate decision-making. Consumer sovereignty is real; most new consumer goods fail the test of the marketplace, despite the best efforts of advertising agencies. In other words, central economic planning in any of its guises does not work, whereas the competitive market does work, and only those firms that respond to market signals have any security.

All this is well established, but the images of business imprinted by refuted doctrines live on in some quarters. If we want a simple fact to put these images into perspective, take *The Economist*'s measure of the significance of multinational corporations in the world economy. In its issue of 27 March 1993, it calculated that the top 100 multinational companies accounted for between 40 percent and 50 percent of all cross-border investments, but only represented about 16 percent of the world's productive assets. That is to say, the world economy consists mainly of small and medium-sized businesses; it always has done, and things are not likely to change. As far as New Zealand is concerned, even its largest businesses are quite small by world standards.

In the last two decades, the critique of corporatism has made great advances as the failures of corporatist policies became obvious and had to be replaced by new policies based on a better appreciation of the facts of economic life. By and large, governments increasingly see their role as creating the background conditions for a successful market economy: providing law and order, enforcing contracts, balancing the budget, keeping prices stable, and making some educational and infrastructural investments that the private sector may be unable or unwilling to undertake. Most governments still have a great distance to go to get back to these core functions, and there are always temptations to backtrack in response to interest group pressures. However, we are living today at a time when liberal ideas have regained the ascendancy and may continue to spread in depth and scope.

The spirit of what has been called modern democratic capitalism has always been best sustained in the United States. Nevertheless, the wealth-creating capacity of the US economy was seriously undermined by the regulatory intrusions of the New Deal, the expansive Great Society welfare programmes and a host of other dubious interventions by legislatures and courts. This mischief has been only partially undone by the reforms of the Reagan era, which the Clinton administrations have extended into areas like welfare. But at the turn of the century, and for all its flaws – many of them self-inflicted – the US or Anglo-Saxon model of capitalism is again showing the way as America extends its lead in productivity, technology and job creation. It stands out by comparison with the failed communist systems, the corporatism that has disfigured some Asian economies, and the struggling welfare states of Europe.

The prolonged boom of the 1990s has stimulated talk in the United States of a 'new economy' that may overcome the business cycle and deliver more or less permanent full employment and economic growth. The major features of this still hypothetical economy are a high level of technological sophistication; much greater flexibility in labour markets; plenty of venture capital to fund new business ideas; an ethos of enterprise encouraged by widespread share ownership; and a policy regime of low taxes (including low capital gains tax), low interest rates (underpinned by a balanced budget), light regulation, and welfare that moves beneficiaries rapidly into employment. As yet the United States only partly approximates this description, and it is naïve to think that the business cycle will ever be fully tamed. I do believe, however, that the vision of the 'new economy' has sketched the features of the emerging new face of business.

After spending most of the century under the cloud I described earlier, capitalism has become more popular in a number of senses. One is the spread and diversification of property ownership. Countries like New Zealand have long been 'property-owning democracies' in the sense that most homes are owner-occupied and most people can aspire to become a home owner. But real estate is a relatively immobile form of property that is only infrequently traded. Owners of stocks and bonds, on the other hand, can become engaged in business by trading them as often as they wish. The rise of private investment and superannuation funds in recent years has introduced indirect ownership of securities to many millions of people. As retirement income provision becomes more and more a private responsibility, these trends will intensify. Privatisation of former state businesses and the demutualisation of mutual companies and cooperatives are deepening investment markets. And all the while the numbers of self-employed are continuing to grow.

Managing a personal portfolio of investments may take time, but the rewards will be considerable in terms of new choices over lifetime career paths (including by financing investments in education and training) and new trade-offs between work and leisure. In such a world, the distinctions carved on the old face of business, such as that between 'bosses' and 'workers', will become increasingly irrelevant. More and more people will acquire a stake in a policy regime that is friendly towards an inclusive, popular capitalism as opposed to the privileged, corporatist version of the past.

A similar, category-dissolving trend is the spread of contracting generally and in the labour market in particular. At one time employment was based on the notion of the master-servant relationship, in which the employer was deemed to 'control' the employee. The Employment Contracts Act 1991 went a long way towards establishing a regime of free contracting in the labour market and consolidating the shift from status to contract. The working relationship is increasingly understood as a matter of voluntary exchange: a far cry from past systems of industrial feudalism, hierarchical control and monopoly trade unionism.

A further feature of the new democratic capitalism is the 'feminisation' of business. Business is proving to be a major force for the emancipation of women. In New Zealand as elsewhere, increasing numbers of women are entering the formerly mainly male preserve of top management. Others are finding compensation in small business. In the United States today, most new small businesses are headed by women; some surveys suggest they are more successful than those started by men. I think there is no more reason to expect similar distributions of men and women in all types and levels of business any more than in other walks of life – talents, preferences and career paths are likely to differ in systematic ways. But markets are powerful forces for penalising discrimination based on unfounded prejudices – for the purposes of business the colour of people's money is more relevant than the colour of their skin. Because they encourage a search for best value, competition and open markets check discrimination and will reveal where the sexes have particular advantages, and no doubt the same could be said for ethnic groups as well.

Bringing marginal groups into the mainstream workforce is one of the most encouraging effects of full employment in the United States. Flexible labour markets have enabled employers there to respond to rising demand for their products by creating more jobs as well as by increasing wages. Partly because of this, the welfare rolls are falling fast. As US economist David Hale put it in the *Financial Times* of 14 April 1997:

> American companies would not usually be enthusiastic about hiring people from the welfare rolls. Their low skills are a barrier to productivity, they require a heavy investment in training – and the US does not have a tradition of apprenticeship. The government spends far less on worker training programmes than other industrial countries. But, given the current tightness of the labour market, companies have little choice but to hire people they would once have shunned. In Chicago, Milwaukee and other mid-western cities, businesses are being forced to recruit untrained workers, with the help of inner-city high school principals and church pastors, because there is no one else to hire.

The lesson for New Zealand, with a Maori unemployment rate now approaching 20 percent, should be plain.

In this way, business is succeeding where government programmes often do not. It is not difficult to work out why training undertaken by the private sector is likely to be more useful than that provided by government, which is often motivated largely by a desire to mask true levels of unemployment. Welfare programmes based simply on handouts to able-bodied people have failed everywhere – they have given people a way to get by without having to do any work or go in for self-improvement. And government-mandated affirmative action programmes have often been shown to benefit allegedly disadvantaged people who are already employed and have prospects, rather than those who most need help.

Higher employment in the United States has contributed to a falling level of crime. The US Justice Department reports that since 1993 violent crime has fallen by more than 21 percent, to its lowest level in at least 24 years, while property crime is down 22 percent since 1973. Other factors have been at work as well, like better law enforcement and welfare reform, but it's obvious that the more opportunities exist for employment, the less attractive a life of crime will seem. Nor is it the case that the new jobs created in such spectacular numbers by America's economy in the 1990s are typically low-paid, unskilled and part-time: in reality, employment is increasing at all points on the income scale, in full-time as well as part-time jobs. Of course the United States does have 'working poor', but they are better off than in most other countries, and they surely have a better chance of working their way up the income ladder than they would elsewhere.

The benign social effects of a well-functioning free-enterprise system should be borne in mind when one encounters the standard moral argument against modern business, namely that it encourages an ethos of greed and selfishness as opposed to one of social concern and community. This argument is tenacious, perhaps because it is the last superficially plausible argument against economic freedom that remains, all the others having been silenced by experience. But it too deserves to be silenced. Greed, selfishness and envy, as well as more noble emotions, are part of human nature and therefore present in all economic systems. The issue is which systems check our baser motives and encourage the better angels of our nature, and on that score central planning, corporatism and political/bureaucratic arrangements fare badly. The exchange relationships of the marketplace socialise us into the elementary virtues, like self-discipline, cooperativeness and respect for others, that we all need to learn if we are to succeed in realising our goals.

Compare the United States and its economic dynamism and falling unemployment and crime rates with France, where business is perhaps more unpopular than in any other Western democracy. There, misguided welfare and labour market policies are locking out of the workforce a huge share of the population under 25 years old. The result is rising social tension and a steady flow of recruits to xenophobic political parties. The French bureaucratic elite likes to view the free market as the 'law of the jungle' – something to be civilised by judicious intervention – and to contrast its social model with what it regards as the individualistic, 'devil take the hindmost' approach of the Anglo-Saxons. One would like to think that the lesson in the different outcomes was self-evident; sadly, it seems not to be.

One reason why the potential of a free enterprise system to promote social cohesion and mutuality remains underestimated is that entrepreneurs are largely barred from entering the market for the delivery of social services. The private service sector is growing rapidly, aided by the Internet and other democratic technologies that can drastically cut transaction costs and lubricate markets. Imagine what business could do if it had unhampered access to the markets for the finance and provision of education, health care and disability services. For this to happen, the present government monopolies in these areas will have to be exposed to potential competition from private entrepreneurs.

Some of this speculation about the changing face of business may sound somewhat implausibly upbeat. It is true that I have been painting an optimistic picture of developments. But there are grounds for optimism. Going into the next millennium, we can see liberal ideas continuing to spread, even though they have yet to take root in some parts of the world. Economic freedom is also a powerful force for greater political freedom. We can see democracy and greater recognition of human rights steadily advancing in regions like Latin America and Asia. And as the nations of the world become ever more closely drawn together through trade and other business links, the prospects for global peace are also advancing: I think it is still the case that no two countries in which McDonald's operates have ever been to war with one another.

A very important reason for optimism in my view is the evidence that younger people by and large do not share the hostility towards business displayed by many of their elders. The people who articulate suspicion of business – journalists, teachers, academics, bishops, lawyers, and so on – largely belong to that generation (the 'baby boomers') that got its university education in the 1960s. Like elites through the ages, too many of them have learned nothing and forgotten nothing since their formative years – not even in the face of the collapse of communism. But they have largely failed to pass on their collectivist ideology to their children, who have been contemptuously called 'Generation X' for failing to mirror their parents' prejudices. My impression is that younger people are generally uninterested in statist philosophies and the machinations of politics. The idea that Washington – or for that matter Wellington – could be described as Camelot would be greeted with derision by most of them. Big government is seen as the dead hand of the past, not the wave of the future. If its allure continues to fade, this could well be the natural and welcome long-term effect of the collapse of the Berlin Wall.

Some evidence for this impression comes from a report in *The Economist* of 17 January, 1998. The American Council of Education has sponsored an annual survey of college entrants since 1966. In that year (when many of today's intellectuals were undergraduates), 60 percent of students thought it important "to keep up to date with political affairs"; by 1997 this figure had fallen to 25 percent. This trend is not universal; for example young people in France seem to have inherited the statist opinions of their parents. But New Zealand resembles the United States in having undergone a programme of economic reform that has reined in the public sector and significantly increased the share of young people who work in the private sector. The long-term consequences of this could be profound. The more people who work in business, the more normal it will become and the more it would be taken for granted.

This, for me, would be the ideal state of affairs: business becomes the everyday activity of life, so long as people want and need to work to support their lifestyles, their income and their retirement. There is surely no more personally rewarding and socially valuable vocation than meeting other people's needs. Business is just the nation in its working clothes. Insofar as we all wear working clothes, as well as other clothes on other occasions, it is simply the sum of the faces of all of us.

CHARTERED INSTITUTE OF CORPORATE MANAGEMENT

BUSINESS ETHICS AND THE MARKET ECONOMY

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BUSINESS ETHICS AND THE MARKET ECONOMY

It is a depressing commentary on the extent to which business can be misunderstood that the whole topic of 'business ethics' strikes many people as little more than an oxymoron – a combination of hopelessly clashing concepts, and a bad joke fit only to be the starting point for other allegedly bad jokes such as 'military intelligence'. To such people, a market economy is a dog-eat-dog world of exploitation, selfishness and greed, and the only ethical principle in business is that you should do unto others before others get a chance to do it to you.

This is not only a caricature but a dangerous one. Few people who are actually engaged in business would hold to it – and those businesspeople who argue that there are no business ethics usually end up bankrupt or behind bars. We need to remember that the majority of our fellow citizens spend their working lives employed by private sector businesses or running them. Do we really think they adopt ethical standards at work that are basically different from those they practice in their personal lives, or that business morality differs fundamentally from personal morality? Remember also that business does not just comprise the high street, the capital markets and the industrial estate: it includes law firms, medical practices and all those organisations that offer goods and services to consumers for reward. One way or another, business involves practically all of us.

Civil societies have always promoted well-recognised virtues – independence, self-reliance, community responsibility, duty to family, hard work, thrift, honesty, sobriety and so forth. These virtues are important in transacting with others, just as much in commercial settings as they are in non-commercial settings.

I will argue that normal business activity is steeped in ethics, and even encourages the development of many human virtues. Yet even among businesspeople, or those sympathetic to business, there is confusion about business ethics. There are unrealistic expectations about the sorts of ethical decisions businesspeople can legitimately take. These confusions largely arise from misunderstandings about the role of business in our society.

Our current levels of wealth – which by the standards of past centuries are astronomical and unprecedented – are largely due to the activity of profit-seeking businesses producing goods and services that consumers value. Despite its apparent complexity, a modern market economy is based on one very simple principle with enormous ramifications. That principle is voluntary exchange. In every market transaction someone voluntarily gives something to someone in exchange for something else, and expects to be better off as a result. Value is created, and each party to the exchange captures some of that value – or else the exchange would not take place at all. In other words, a market system involves cooperation for mutual benefit. This cooperation may involve people of different races, religions and political views. They may agree on very little other than the benefits they derive from making the exchange.

Much of mainstream economics consists of analysing exactly how and why the voluntary exchange of goods and services within a sound legal framework will spread wealth throughout society. The discipline of economics explores how the price mechanism signals consumer preferences and resource scarcities. It explains how the profit motive induces businesses to discover consumer preferences and cater for them at least cost. The search for profits motivates the development of new technologies and the willingness to undertake the investments likely to provide the greatest pay-back to society. Competition between firms to serve the consumer drives down prices and spurs innovation. Market transactions, based on the price mechanism, coordinate the actions of countless people, most of whom will never meet or know one another. In short, the 'invisible hand' that Adam Smith identified over 200 years ago in his classic book *The Wealth of Nations* tends to lead businesspeople seeking profits to serve the wider interests of society far more effectively than the cleverest central planner. Smith's insight is borne out by the success of the Anglo-American market model over the last two hundred years, by the collapse of communism, and by the connection increasingly found between economic freedom and economic growth.

Once we understand that cooperation is fundamental to production, distribution and exchange, it becomes quite implausible to imagine that market transactions can exist in an ethical vacuum. Not only does the ability to do business depend on upholding a range of ethical standards but markets themselves also promote ethical standards more effectively than many other social institutions. We would not expect individuals to be inherently more moral in their business lives than in their private (non-business) lives. There are no moral policemen keeping immoral people out of business activity. But many features of business activity strongly encourage moral behaviour. One is that markets are based on trust. If two people are to make a voluntary exchange, there must be a degree of trust that both will stick to their sides of the bargain. To be trusted it helps materially that you exhibit good character and ethical behaviour – that you are honest, fair to people, and deal in good faith. Because legal contracts can't cover every contingency and are costly to enforce, reputation and integrity are particularly important in business relationships. Hence the bond trader's saying: 'My word is my bond'.

Perceptive commentators have long noted the link between the demands of successful commerce and the encouragement of moral behaviour. For instance, the London Stock Exchange of the eighteenth century impressed the French Enlightenment thinker Voltaire who wrote:

> Go into the London Stock Exchange – a more respectable a place than many a court – and you will see representatives of all nations gathered there for the service of mankind. There the Jew, the Mohammedan, and the Christian deal with each other as if they were of the same religion, and give the name of infidel only to those who go bankrupt. There the Presbyterian trusts the Anabaptist, and the Anglican accepts the Quaker's promise.[1]

There was very little formal regulation of the stock exchange at that time. But the Presbyterian still trusted the Anabaptist because they knew the latter had a strong incentive to keep their word.

A feature of many markets is that they involve repeat transactions. If you break your word on one occasion there will be an erosion of trust, and in future you will find it more difficult to convince others to do business with you. A few fly-by-night operators will try to evade this logic but they cannot evade it for long: lasting success in business requires a reputation for honesty and commitment to one's customers, and constant efforts to maintain it. Even if a firm's business is such that individual customers return only infrequently – as in the case, say, of a seller of consumer durables – reputation does not cease to be important. A free media, the power of word of mouth, consumer groups and the variety of other organisations that advise consumers together ensure that a firm's good name remains crucial. That is why many businesses invest so much in the establishment of brand names.

Anyone doubting the importance of reputation should consider the case of the US securities firm Salomon Brothers, that was found to have been involved in illegal bids for Treasury bonds. The fallout from that scandal in the form of legal sanctions against Salomon was minor in relation to the effect on the firm's share price. The damage to its reputation led to a far greater part of the fall in the expected value of Salomon's future

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1 Quoted in Norman Barry, *Business Ethics*, Macmillan Press, London, 1998, p 91.

profits. Reputable people try to avoid doing business with people whose reputation is dubious, or to deny them trust when they have to deal with them. Both these responses promote civil behaviour.

Another cardinal virtue of business is honesty, and a high proportion of the business scandals that do erupt involve lapses of honesty. A business needs to be honest to the various parties who rely on its word – to its employees, its suppliers, and its consumers, and to the capital market through the integrity of its financial reporting. But there are other ethical virtues that commercial businesses have every incentive to display. They will be encouraged, for instance, to treat people and other organisations on their individual merits. A truly profit-maximising business will not be racist, or sexist, or xenophobic, because to act in these ways will hurt the bottom line of the company – unless it is shielded by government interventions that enable it to exercise its prejudices without cost. Thus an ethical business will choose a supplier on the basis of its ability to fulfil orders of the right quality, at the right price, with the right consistency. It will not choose a supplier, or a partner for a joint venture, just because its chief executive went to school with the firm's own chief executive, or on grounds of race, or gender, or nationality, when these features are not relevant.

Similarly with employees: an ethical business will hire and promote applicants who are best qualified to do each job, and will pay each person according to the value they contribute to the organisation's goals. It will discriminate only where there are good business reasons to do so – such as merit. Not only will it refrain from indulging in blind prejudice against classes of people but it will also not succumb to the politically correct temptation to put in place quotas for minority groups, because doing so would simply be another way of treating people unfairly. Again, good ethics is good business.

Moreover, since markets involve inter-personal cooperation, they also encourage the development of characteristics that smooth human relationships, such as courtesy, friendliness, good humour, thoughtfulness and kindness. It is no wonder that perceptive social critics such as David Hume in Britain and Alexis de Tocqueville in France long ago noted the role of commerce in civilising the manners of those peoples who embraced it.

However, while markets may encourage many virtues, the relationship is by no means one-way: business also draws crucially upon the cultural capital already in society. Markets work best when there is a sustaining tradition of personal integrity, honesty, trust, foresight and civil cooperation. This cultural capital is maintained and strengthened when key institutions in society are all successfully doing their work. In western societies the conditions for successful markets took centuries to evolve, and in some parts of the world they are weak at best, even to this day.

To understand the importance of a healthy civil society we need only compare the economic performance of the various ex-communist societies since the collapse of the Soviet empire. Even though they continue to face many difficulties, some countries such as the Czech Republic have made rapid progress with economic liberalisation. By contrast, the Russian economy remains mired in stagnation, and – despite a fair degree of reform – lurches from crisis to crisis. One important reason is that the Czech Republic has a stronger, more resilient civil society than Russia. It experienced a shorter period of time under communism, and retains from its earlier history some of the cultural capital that communism set out systematically to destroy.

The lesson for New Zealand is that providing a setting for a successful, ethical business sector is a task for all of society – for families, schools, universities, news media, churches, other voluntary groups and businesses themselves. New Zealand has an admirable record of low levels of fraud and corruption in business, despite attempts by some to sully it for self-serving reasons. This has regularly been borne out in surveys by Transparency International. To be sure there are lapses from proper standards in business, just as there are in other walks of life, and they should be met by social opprobrium and, in the case of unlawful behaviour, by legal penalties. But even in the case of the events surrounding the worldwide sharemarket crash of 1987, that are often seen as an episode of business conduct that was dubious or worse, the incidence of outright wrongdoing in New Zealand was small, even by comparison with Australia. Mostly it was a story of over-enthusiastic and imprudent entrepreneurs and equally careless and sometimes greedy investors, and of tax and commercial law that had not caught up with the requirements of an open economy, rather than a story of business dishonesty. Most of the property and investment companies that failed would have done so as a result of the collapse in asset values relative to borrowings, regardless of any wrongdoing in the way they were run.

I have argued so far that good business behaviour is typically good ethical behaviour. But we must guard against a serious mistake – the confusion of the duties and responsibilities of business (and other legal entities) and those of all of us as private citizens. This all-too-frequent error is the source of much ill-informed criticism of business. Often people complain that public companies should display more 'social responsibility' – that the executives or directors of these companies should, for instance, be more generous in donating company money to worthy causes. Yet this idea misunderstands the nature of a public company and attributes certain characteristics to a firm that can only belong to people.

The role of a company's employees is to assist in maximising long-term shareholder value. All their actions, including their dealings with everyone involved with the company, must be to this end. Those running the company are the trustees of the savings of thousands of ordinary people who have invested in it. Sometimes making donations to worthwhile projects can be justified by the favourable publicity or other benefits it generates for the company. Otherwise, it is a simple breach of fiduciary duty on the part of corporate officers. This is true no matter how generous they might be as individuals. As the Australian philosopher Bob Ewin has put it:

> It is not that corporate officers *should not* be generous; they cannot, *logically cannot*, be generous in that sort of situation. When they are acting in their personal capacities, asked for a loan by the secretary or for a charitable donation from their own pocket, they can be generous; when asked to take on extra work so that somebody else can have a day off for grandmother's funeral they can, as a personal favour, agree, because that is a personal sacrifice within the corporation and not a sacrifice of the corporation; but in acting *for the corporation* they cannot be generous.[2]

There is nothing generous or legitimate about giving away other people's money, which is precisely what happens when corporate officers give away shareholders' funds, just as an employee has no right to give away an employer's goods or a bank to give away its customers' deposits. And just as a corporation in the abstract cannot be generous, so it also cannot be selfish or greedy. A corporation can be successful or unsuccessful at increasing shareholder value, but it cannot be selfish. Anybody wanting to apply a label of selfishness must seek out specific individuals acting in their own capacity: they must argue that shareholders of a corporation are selfish. However, now they are simply saying in effect that a particular John Smith of Palmerston North, who holds shares in a particular company, is a tightwad who never does a good turn for anyone, and should donate money to a local charity.

That might be true of some shareholders. However, it is absurd to argue that all shareholders of a corporation will be selfish, or that it is an act of selfishness to invest in a corporation rather than donate money to a charitable organisation. Such an attitude

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2 R E Ewin, *Why Worry about Business Ethics*?, Institute of Public Affairs, Melbourne, 1992, p 45.

confuses self-interest with selfishness. The savings of individuals help to provide investment capital, which in turn leads to economic expansion and higher living standards. Moreover, if an investor attempts to get the best risk-adjusted rate of return on their equity capital, they are simply playing a part in the ongoing process of channelling savings into investments that provide the best rate of return for society as a whole. Their action may be self-interested, but it cannot be condemned as bad for society. As we have seen, the self-interested actions of individuals can be justified by their wider, indirect, impact: that is Adam Smith's insight about a market economy. Moreover, all other economic systems are based on self-interest. The difference with a market system is that self-interest is moderated by the disciplines of markets, that do not rely on coercion.

None of this is intended to deny, of course, that giving money for charitable purposes is typically a morally praiseworthy act. But the praise is due to an individual: we cannot get away from the fact that ultimately it is individuals who make moral decisions. Moreover, the sorts of moral decisions they make will influence the type of business sector we have. Critics often lambast business for harming the environment, causing unnecessary suffering to animals, producing various harmful and decadent goods, promoting a culture of mindless consumerism, and many other failings. Yet it is individuals as consumers, acting in their own capacity as free moral agents, who finally bring about the pattern of goods and services that one sees in a market economy. If there is no demand for particular goods and services, businesses won't produce them.

Thus while only the owners of a business have the right to specify a particular objective for the use of their funds, all of us as individuals can influence business behaviour. As Elaine Sternberg has remarked in her book *Just Business: Business Ethics in Action*:

> By choosing whether or not, and to what extent, to support particular businesses with their investment or custom or labour, everyone can contribute to the economic conditions that critically affect business decisions. If, therefore, individuals have views as to how business should be conducted, they should ensure that their individual choices accurately reflect those views. If they find the product or the manufacturing process objectionable, or consider the service or the advertising offensive, or judge the declared values of the board or the management to be misguided, then it is up to them not to support the firm. When each potential stakeholder – otherwise known as every member of society – acts conscientiously in his personal capacity, and strategically bestows or withholds his economic support on the basis of his moral values, then the operation of market forces will automatically lead businesses to reflect those values.[3]

That might mean refusing to work for a certain business if you believed it was selling a harmful product. It might mean refusing to hold shares in a multinational company if you could not support its decision to invest in a country with an undesirable political regime, or if you believed its marketing techniques to be dishonest. It might mean refusing to consume goods whose production involved experiments on animals, if doing so conflicted with your convictions on animal welfare. Moreover, if you value non-business ends highly, by directing a large proportion of your spending outside the business sector you will influence the total extent to which society as a whole channels resources to business.

What these examples illustrate is that morality must be about action – not just thoughts and rhetoric. To be genuine, our morality must shape our behaviour. Yet in a free society there is much room for debate about moral behaviour, and there is no shortage of ethical controversies. We should not try to legislate for morality. We must inevitably be

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3 Elaine Sternberg, *Just Business: Business Ethics in Action*, Little, Brown and Company, London, 1994, p 257.

prepared to accommodate different views about ultimate values, provided all of us stay within an agreed framework of law. Markets, properly structured, can be a vehicle in which these different views are accommodated.

If we feel offended at some of the outcomes thrown up by the market, the answer may lie in ourselves. To simply ask of business to fix all the ills of the world, while doing nothing on our own account except criticise business as 'greedy', is an abdication of responsibility. It is about as realistic and as ethical as simultaneously demanding lower taxes and more government spending. Just as it is important to have an educated electorate, that knows what it can and cannot realistically require of politicians, so it is important that the wider society understands what it can legitimately ask of business. That is why those educators who associate business with greed, or teach students that markets exploit workers, create confusion about the nature of business ethics. By continuing to peddle long-exploded fallacies, they create a culture suspicious of business and envious of those who are successful. To the extent that they succeed, the whole of society is the poorer.

INSTITUTE OF ECONOMIC AFFAIRS

THE ROLE OF BUSINESS IN PUBLIC AFFAIRS: SOME NEW ZEALAND PERSPECTIVES

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THE ROLE OF BUSINESS IN PUBLIC AFFAIRS: SOME NEW ZEALAND PERSPECTIVES

1 Introduction

In this talk I want to explore the tensions between two ideas.

The first idea is that because the only role of business is to meet consumer needs, the long-run interests of the business sector as a whole are largely consistent with those of most consumers. Consumers' interests are best served by an efficient economy that delivers them the goods and services that they want with the most economic use of available resources. From this perspective, the size and growth of the economy and the opportunities for business will be maximised by policies that encourage economic efficiency, such as open and competitive markets and smaller rather than larger government. It is therefore in the interests of business at large to promote such policies. They focus on expanding the overall size of the cake and are in the general public interest.

The second idea is that democratic politics is strongly influenced by special-interest groups, including business firms and industries that favour government programmes that confer substantial benefits on them while imposing smaller costs on a larger number of citizens. Governments are susceptible to lobbying by specific producer interests for protection, subsidies, regulation and other favours at the expense of the mass of unorganised consumers, taxpayers and other producers. From this perspective, individual businesses or industries have strong incentives to engage in rent-seeking behaviour to promote their private interests. While this results in a cake of smaller size, they obtain a larger slice of it if successful. Adam Smith wrote of the tendency of firms to conspire against the public interest and the idea has been greatly refined and developed in modern public choice theory.

In recent decades the private-interest view of business and the political process has been in the ascendancy. Those of a market-liberal persuasion have often seemed pessimistic about defeating what Milton Friedman has called the "iron triangle" of special-interest groups, politicians and bureaucrats. Certainly there has been a great deal of evidence in support of the view that there are strong political incentives for ever-increasing growth in government spending, taxation and regulation. On the other hand, there are countervailing influences, including ones that can be mobilised within the business community, as I propose to show.

I want first to discuss in a little more detail some aspects of the conventional views about politics and interest groups, and their implications for public policies and economic performance. Next I shall touch on some other general features of business-government relationships that various writers have rightly criticised. I shall then consider these elements of theory and practice with reference to recent New Zealand experience. Finally, I shall give some reasons for questioning a narrow or fatalistic interpretation of public choice theory and argue that business interests can be joined with those of think tanks and others in promoting market-liberal causes.

2 Special interests and the public interest

Only a generation or so ago, courses in political science reflected a more benign view of interest-group politics than is the case today. Interest groups were often regarded as a necessary and useful feature of the political process. In large modern democracies, politicians were seen as incapable of ascertaining the views of unorganised, individual electors. Representative interest groups were the means of filtering their views to politicians. The job of politicians was to mediate these views, resolve any conflicts and translate them into policies.

There was at least a weak assumption that the representations of major interest groups were in the public interest – as their spokespersons typically maintained they were. Representatives of corporations could argue that "What's good for General Motors is good for America" in a way that would not be possible today without courting scepticism or outright mockery. Beer and sandwiches in Downing Street with trade union and employer representatives were one manifestation of this climate of opinion. The growth of organised interest groups was part of the ever-increasing dominance of government in the economy, and corporatist approaches to economic management were viewed favourably by many. Today we would be more likely to label such approaches, as manifested in Russia and some Asian countries, as 'crony capitalism'.

Such theories of interest-group politics were naïve, and were exploded by the public choice analysis associated with names such as James Buchanan, Gordon Tullock and George Stigler. This body of scholarship emphasised the incentives of business and other groups to lobby for self-interested purposes. On the other side of the bargain, it exposed the tendency of politicians to govern not in the public interest but in the interests of constituencies to which they were beholden. Politicians were seen as rational maximisers of voter support, seeking to increase their popularity and chances of being re-elected. They would therefore yield to pressures from organised groups with political clout, favour special interests rather than the general interest, and support policies that promised expedient 'quick fixes' rather than durable but less popular solutions.

Other writers like Mancur Olson developed these ideas, noting that the accumulation of interest-group-driven policies distorted economic decision-making, fossilised institutional arrangements, sapped wealth creation and undermined economic growth. Olson observed that interest-group politics tend to develop a stranglehold in countries that experience long periods of stability and are broken in times of great upheaval: this helps explain, in his view, the post-war success of countries like Germany and Japan. New Zealand's isolation from world disturbances and the stable and intimate nature of its politics were conducive to interest-group sclerosis. Its long period of relative economic decline this century – after achieving one of the world's highest levels of average income per capita – fits Olson's hypothesis well, as does the reappraisal of its economic directions that followed the debt-induced economic crisis of 1984.

Public choice theory has been shown to have great predictive power. In the business sector, it helps explain the prevalence of policies such as protection against foreign competition, farm subsidies, industry licensing, handouts to both 'sunrise' and 'sunset' industries, restrictions on company takeovers and much else. Outside business the same incentives – to favour narrow interests at the expense of the general interest – can be seen at work in areas as diverse as occupational regulation, subsidies to higher education, arts funding, state pensions and minimum wages.

Public choice analysis also offers insights on the likely behaviour of different parts of the business sector.

First, it suggests that the large numbers of small businesses, like the large numbers of consumers and taxpayers, are less likely to be able to organise effectively, engage politicians' attention and obtain government favours. They are therefore more likely to support free-market rather than interventionist policies. The Federation of Small Businesses in the United Kingdom fits this mould, as does its counterpart in the United States. When I worked in the New Zealand Treasury a popular in-joke was that the best way to help small business was to keep representatives of big business out of politicians' offices.

Secondly, in terms of public choice theory, organisations with broad sectoral representation may be more likely to adopt a national-interest perspective than those that represent specific industries or groups. In a paper that I wrote as a Treasury official, I suggested that:

> … interest groups with broad representation, which are thus forced to take a more economy-wide view, may be a source of influence that is more coincident with the interests of the community at large. [1]

In similar vein, William Niskanen, president of the Cato Institute and a former member of the US Council of Economic Advisers, recently made the point to a Japanese business audience that:

> Firms and industries that seek special favours … encourage other firms to seek similar favours, corrupt the political process, and undermine political support for capitalism.
>
> In this sense, every firm that seeks a special favour creates a public bad. … Any one firm is torn between playing the game to gain a special favour and supporting a principle to preserve the system. That is why it is especially important for broad-based business organizations like the Keidandren to maintain their support for the principles that preserve capitalism and constitutional government.[2]

However, this proposition does not always seem to hold: the United States Business Roundtable and the Confederation of British Industries (CBI) tend to adopt more statist positions than the organisation I now work for, the New Zealand Business Roundtable. One thinks, for example, of the former's record of lobbying for anti-takeover regulations – a management protection charter – and the call by Sir Terence Beckett as CBI president for a "bare-knuckle fight" against Mrs Thatcher's reforms.

3 Weaknesses in business lobbying

In an article in *The Wall Street Journal* entitled 'What's Wrong with Business Lobbyists', Fred Smith, president of the Competitive Enterprise Institute, wrote:

> Firms and industry trade groups spend ever-greater sums successfully purchasing "access" and "influence" in Washington, but still manage to lose ground over the long run. Despite some notable gains in deregulating a few markets, the competitive economy on which business prosperity ultimately rests is gradually being eroded.[3]

One of the problems identified by Smith is that, to many firms, principled defence of business interests appears ideological, "which indeed it is". "Ideas, however, do matter," he argued, "and it is important that business realizes this".

The best response to any criticism that a position is ideological is to point out that any alternative position is ideological also. The term evokes the notions of ideas and logic, and

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1 Republished as *Ideas, Interests and Experience*, Centre for Independent Studies, Sydney, 1988.
2 William A Niskanen, 'Deregulating the Japanese Economy', *Cato Policy Report*, July/August 1998.
3 *Wall Street Journal*, 16 January, 1987.

the debate must be about the quality of both. The case for free trade, for example, is based on certain ideas and logic, just as is the case for protection. It so happens that the 'ideas' and 'logic' justifying protection are wrong and those justifying free trade are right – at least according to the theoretical and empirical findings of the overwhelming majority of economists.

A country is not a company, and the body of knowledge needed to understand how an economic system operates is quite different from that required to run a business enterprise. Business people often fall into the trap of thinking that running the economy is like running a firm, hence the common attachment to corporatist approaches. Moreover, they tend to regard themselves as pragmatic rather than 'into' ideas, and are often not well informed about issues outside their own professional experience – which is surely true of most of us. But successful business people do understand the importance of expertise and professionalism in business affairs and can readily grasp the need for the same attributes for successful engagement in public affairs. Persuading them that they will not win without such capabilities, and without developing strategies on the same fundamental basis as they develop their business strategies, is not necessarily a difficult challenge.

The converse of not taking a principled stand is to engage in the tactics of accommodation and compromise. Joseph Schumpeter criticised the habits of business representatives when attacked by opponents in the following terms in his pessimistic book, *Capitalism, Socialism and Democracy*, written in 1942:

> They talk and plead – or hire people to do it for them; they snatch at every chance of compromise; they are ever ready to give in; they never put up a fight under the flag of their own ideals and interests – in this country there was no real resistance anywhere against the imposition of crushing financial burdens during the last decade or against labor legislation incompatible with the effective management of industry.

Thus business representatives faced, for example, with a proposed hike in the minimum wage from, say, $5 to $6 are often inclined to bargain for a lesser increase, rather than to argue that minimum wages are fundamentally harmful, especially to the interests of young and unskilled workers – a position that attracts almost as much support amongst economists as the case for free trade. Usually they lose, and at the same time they have conceded the legitimacy of their position.

Even worse, as Paul Weaver describes in his 1988 book, *The Suicidal Corporation: How Big Business Fails America*, corporations have often funded consumer, environmental and other groups that campaign for policies that would be highly damaging to their long-term interests and those of the wider community. Their chief executives seek to deflect the focus of such groups elsewhere, or to use the government's powers to impose penalties and regulations on their competitors. They are like the miserable figure Ronald Reagan described as the fellow who hoped the crocodile would eat him last.

A further failing on the part of business is timidity: often business representatives will not stand up and be counted even in the face of serious threats to their interests and the economy. They may be afraid of offending the government or another political party, of political retribution, of consumer boycotts or simply of the unpopularity of defending an unfashionable proposition. The problem for them is that their opponents have no such fears and scruples, and that arguments cannot be won without arguing with them. Business associations have a role to play here, by reducing the exposure of individual businesses and their representatives, but public opinion is often swayed more effectively by someone prepared to take a personal stand.

4 Some New Zealand perspectives

New Zealand is a prime example of a country whose economy was shaped by government interventions that were usually motivated by the specific interests of a pressure group, as well as by a longstanding attachment to mistaken ideas. As Rolf Porter, an able and far-sighted businessman, put it in 1971:

> New Zealand is possibly the most state socialistic country in the world outside the Iron Curtain and it is we, the industrialists, that have made it so by always running to the government … .

The most powerful business organisation in old New Zealand was the Manufacturers Federation. It used to be said that presidents of the Federation had to be buried six feet deep so that they couldn't get a handout. The former prime minister, Robert Muldoon, believed that Manfed's opposition to some tentative efforts by the National government to free up import licensing cost it the 1972 election. National remains timid about free trade to this day, even though the majority of the business and farming communities now support it. Other powerful interests in old New Zealand included the unions, whose support for centralised wage controls was needed to offset the price-increasing effects of import restrictions, and the farmers, who were given subsidies in an ultimately fruitless effort to maintain their international competitiveness in the face of high domestic costs and inflationary policies. The whole economy became one huge interlocking grid of special interests, walking around with their hands in one another's pockets, and in the early 1980s the whole edifice fell over.

A key principle of the New Zealand reform programme that began in 1984 was that special interests should no longer be allowed to dominate the wider interests of the community. Every New Zealander is, ultimately, a consumer whose interests lie in having resources used in the most efficient manner. In the end, enough sector groups realised that everyone would benefit if we had an economy in which no one's special interest held the legitimate interests of others to ransom.

The New Zealand Business Roundtable (NZBR) was formally established in 1986 by a group of business leaders who had come to realise that the old ways had run the country into the ground. Today it is an organisation comprising 50-60 chief executives of our largest firms and its sole concern is with national policy issues – we provide no 'private good' services to members. Our founding document states that:

> The NZBR 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. … In an open and free domestic and international market environment, the interests of the business sector are closely aligned with those of the community at large. As a broadly based organisation, the NZBR's focus is the general economy rather than particular sectors or industries. This requires it to take an objective, non-partisan and longer-term view, rather than to operate for the benefit of any one group at the expense of others.

One way of thinking about such a business organisation is that it is a response to the familiar prisoner's dilemma, the central model of constitutional political economy. Enough business leaders had realised that autonomous business groups organised around industry and sector interests were locked into promoting the non-cooperative outcome in which everyone was worse off. They formed the NZBR because they saw that everyone could be better off if there was enough support for the welfare-maximising cooperative solution to make a difference. They were not in any way acting against the long-term self-interest of the business sector at large; to the contrary they were pursuing it in a way that aimed to produce public goods rather than public bads. Expanding the size of the cake was seen as a better strategy, even from a self-interested point of view, than scrambling for a larger share of a smaller cake. An interesting irony is that those who favour mandatory collectivist solutions to public policies attack the NZBR for being individualistic (which it is in the sense of fighting to preserve and enhance the scope of individual choice) but they fail to see that it also represents a voluntary cooperative response to a collectivist (public good) problem.

Having nailed our colours very publicly to the mast of a national-interest goal, we are condemned to operate accordingly or lose credibility. Roger Douglas, the initial architect of New Zealand's economic reforms, observed in a 1987 book that:

> … [members of the NZBR] are prepared to go back to first principles and argue from there instead of presenting the usual parochial points of view. If they don't, they realise it is much easier for someone at some stage to knock over their case.[4]

Twelve years down the track I am prepared to claim that we have stuck firmly to those principles and have not engaged in special pleading, and there has been no serious pressure within the organisation to do otherwise. The committed leadership of a few individuals was one factor that made a difference. A handful of members who decided they did not fully share the organisation's perspectives simply resigned in the early days, because they saw the majority of members were committed to them. If we have unwittingly erred at any stage, the responsibility lies with me as chief executive for deficiencies in research and analysis, not with the membership. As a newspaper columnist put it recently:

> Anyone who reads the material (as distinct from raising their very hackles at the mention) of the Treasury, the Reserve Bank or the Business Roundtable, knows national welfare is the goal.[5]

Of course it is one thing for an organisation to commit itself to a national-interest objective; it is quite another to achieve widespread public acceptance that it adheres to such a stand. As Fred Smith has put it:

> The tendency of too many business groups over too many years to use free-market rhetoric to mask special-interest appeals has rendered their views suspect.[6]

Especially given New Zealand's socialistic past and the stance of business organisations over the years, it is hardly surprising that we have encountered many accusations of narrow self-interest, greed and undue influence. The public is not used to interest groups that behave differently: in his book, *The Triumph of Politics*, David Stockman remarked that he did not encounter one group that lobbied for the general public good in his time as Ronald Reagan's budget director. Ultimately, however, politicians and others have to reckon with the message not the messenger, and there have been far fewer serious attempts to dispute our policy conclusions in a careful academic manner. We rely for any influence we may have mainly on research and published material: the number of contacts we have with politicians is quite limited. Moreover, we have not been accused of timidity in persisting with arguments that initially encountered intense opposition from interest

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4 Roger Douglas (1987), *Towards Prosperity*, David Bateman, Auckland, p 79.
5 John Roughan, *New Zealand Herald*, 11 September, 1998.
6 *Wall Street Journal*, *loc cit*.

groups and others but that gradually became accepted and found their way into policy. Challenging sacred cows is never a recipe for popularity.

Of course, there have been many other politicians, organisations and individuals who have promoted similar ideas in New Zealand over the last 15 years or so, and they have been in line with worldwide trends. It is therefore impossible ultimately to fathom what contribution we may have made to the changes that have occurred. What is interesting to note is that, with the exception of a handful of individual voices, practically the whole of the business community as represented through national business organisations has moved to policy positions similar to our own. An illustration was the universal rejection last year by all the major business organisations of $100 million of so-called business assistance included in the package negotiated by the coalition government partners after the last election. This stance, I believe, would find few parallels around the world. The consistency of business sector attitudes has been one of the more positive features of the New Zealand environment in recent years as governments have allowed economic policies to weaken and economic problems to accumulate again, and persistence with this stand offers the best hope of rebuilding a political constituency for policy improvements in the medium term. David Henderson, an experienced OECD observer, has said that nowhere else in the world have members of the business community been prepared to play such a role.

5 Conclusions

The articulation of public choice theory – the economics of politics – over the past 30 years has been an important achievement. It has shed much light on how politicians, under the influence of organised lobby groups, work frequently to advance private interests rather than the public interest. However, the lessons to be drawn from public choice analysis do not need to be defeatist or even pessimistic. Were the strong-form versions of public choice to be taken literally, it is hard to see how the worldwide moves towards deregulation, privatisation and greater economic freedom over the past two decades could have happened. Many would argue that these changes have not gone far enough, but the fact that they have occurred at all suggests the need to look for other explanations.

A first explanation, I suggest, is that in a sense public choice theory has sown the seeds of its own demise. By that I mean there is now a heightened consciousness of the phenomenon of rent-seeking and greater scrutiny of the claims of distributional coalitions. The influence of 'iron-triangle' interest groups will only be maintained in the long run with the help of non-interested parties. When that support weakens, perhaps as a result of better-informed public opinion, rent-seeking becomes less profitable and less socially acceptable.

In the business community in New Zealand, it is now almost bad form to lobby for government handouts, and there is greater awareness of 'provider capture' in areas such as health and education. Producer interests came to accept that economic output would be higher, and all sectors considered jointly would be better off, if some force other than immediate self-interest induced all groups to forgo rent-seeking activity. The dynamic that developed was that one group was prepared to accept the loss of its privileges provided others were treated likewise. Moreover, industry groups had come to realise that privileges could be 'rented' but never 'owned', and the costs of paying the 'rent' – in the form of expenditures on lobbying – were a deadweight loss to them as well as the economy. Outside the producing sectors in New Zealand, however, there has been little sign that rent-seeking has diminished among welfare, cultural, environmental and ethnic lobbies.

Secondly, as I have argued, there is scope for voluntary, cooperative solutions to some of the 'public good' problems associated with promoting better public policies. These relate essentially to the fact that the benefits of successful efforts to promote better policies accrue to all, and others can free-ride on those who make them. New Zealand's experience suggests, however, that many people in business may come to recognise that it is not in their interests to spend their careers struggling to run their firms in a third-rate economy, and that they are prepared to take a broader and longer-term view even though a shift to better policies may harm their firms in the short run. There have been free-riders in New Zealand who have not contributed to the business community's collective efforts, but they have not made them unviable. As I read it, at least the Virginia school of public choice theory does not deny the possibility of spontaneous, voluntary solutions to the public good problem. Only hardline Marxists see the world as composed of conflicting groups, the inevitable activity of each of which is to pursue its own interests at the expense of others, and deny the possibility of cooperative solutions.

Finally, too literal an interpretation of public choice theory overlooks the power of ideas. Ideas about economics and politics ultimately influence the political process irrespective of group pressure. Otherwise how would change occur? One of Keynes's insights in the *General Theory* that was unquestionably right was that "the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas".

It was mistaken ideas about policy – essentially the adoption of "socialism without doctrine" as a European visitor to the country early this century put it – that accounted as much as interest group lobbying for New Zealand's long-term economic decline. An important insight of David Henderson's, that he has revisited in his book *The Changing Fortunes of Economic Liberalism: Yesterday, Today and Tomorrow*, published by the Institute of Public Affairs (IPA) and the NZBR, is that influential ideas are not confined to academic circles. Even educated public opinion is clearly influenced by strongly held intuitive notions about economic issues, relationships and events. The notions of what Henderson has called 'do-it-yourself-economics' are characteristically centralist and anti-market. These have influenced the course of policies in many countries, including New Zealand. The progress of economic liberalism over the past two decades suggests that opinion is shifting, but support for it is still far from conclusive. However, the potential for good ideas to drive out bad over time is arguably the best hope for overcoming both the continuing influence of pre-economic thinking and the power of vested interests. Better policy making might also be encouraged by well-conceived constitutional rules such as those embodied in New Zealand's Reserve Bank Act 1989 and Fiscal Responsibility Act 1994.

In an IEA address, the former GATT (General Agreement on Trade and Tariffs) economist, Jan Tumlir, referring to government attempts to mobilise service industries and consumers to lobby for liberal trade, remarked:

> What an absurd system it would be where an obviously reasonable policy could be sustained only if these two large masses of citizens could be organised in active support of it. … If the issues of liberal trade and protection were presented to them in their capacity as voters and electors, fully, simply and intelligently, why should any politician doubt that their response would be equally intelligent?[7]

It is here, it seems to me, that there is scope for stronger alliances between the purveyors of ideas in the market-liberal think tanks and the entrepreneurial class in business. Such

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[7] Jan Tumlir (1984), 'Economic policy as a constitutional problem', Harold Wincott Memorial Lecture, Institute of Economic Affairs, London.

alliances are not always seen by many in the think tank community as natural – and often for good reason, given the public policy stance of many business organisations. However, I have argued that malign stances by business are not inevitable and indeed that is in the larger interests of business, properly conceived, to make the case for a liberal economy and society. If business will not make the case for free enterprise, who will? Like-minded think tanks – which of course have often been endowed by individual business people – are one of businesses' few allies in this role. In my view the best strategies for both parties are similar; as Fred Smith has argued:

> If business is to defend its long-run interests successfully, it must ensure an adequate defense of the free market. It should adopt the approach pioneered by liberal public-interest groups: find areas where a difference can be made, create rather than respond to an agenda, marshal intellectual and political forces, and seize the moral high ground.[8]

New Zealand's experience offers some grounds for hope that this can be done.

8 *Wall Street Journal*, *loc cit*.

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