# Wake Up New Zealand

NEW ZEALAND BUSINESS ROUNDTABLE
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The New Zealand Business Roundtable is 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.

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# FOREWORD

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

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

It includes an article by David Henderson, consultant to the NZBR.

A full list of NZBR publications is also included.

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**TAURANGA**
**11 AUGUST 1999**

# WAKE UP NEW ZEALAND

Recently a newspaper column by former *Metro* editor Warwick Roger made me sit up and think. It was a kindly reflection on the late Bruce Jesson, a fellow journalist and non-stop critic of most of New Zealand's economic changes in the past 15 years. Warwick Roger wrote that, to the best of his knowledge, Bruce Jesson had spent the whole of his career in New Zealand – not once had he left the country.

If Warwick Roger is right, it may explain a lot about Bruce Jesson's writing and much of the ongoing political debate in this country. People speak of the tyranny of distance, by which they mean New Zealand's remote location, far from major world markets for exports and imports. That is something of a handicap, but even at a time when transport and communications were far slower and more costly than they are today, it did not prevent us being a high income country. Much more important in my view, as Bruce Jesson's writing demonstrates, is the tyranny of insularity, bred of decades of fortress New Zealand policies and an intellectual climate cut off from developments abroad. This continues to make it extremely difficult for many New Zealanders to come to terms with trends and thinking in the world around us.

When I look back, I reflect on how many of my own formative experiences came from the time I spent living or working in other countries, absorbing lessons about those countries through reading, and trying to understand New Zealand, its problems and its opportunities in relation to the rest of the world.

In my own business, the liquor industry, for example, I was struck decades ago by the more civilised approach to drinking in European countries whose legislative regimes were far more liberal than New Zealand's. Parliament deserves credit for its recent decision to abandon another element of New Zealand's repressive past and lower the drinking age from 20 to 18 years of age. But it has taken New Zealand years to catch up, and despite the evidence from abroad – and at home since the Sale of Liquor legislation was relaxed in the late 1980s – many people in our universities and elsewhere still fail to see the link between greater freedom and more responsible behaviour, and the need for properly targeted rather than blanket sanctions.

Take, as another example, the decades of public dissatisfaction with outcomes in health, education, welfare and the Accident Rehabilitation and Compensation Insurance Corporation (ACC). In all these areas government ownership, provision, regulation and funding dominate. Some, like Jim Anderton and Sandra Coney, spend much of their careers attacking the outcomes produced by big government. But extraordinarily, despite the size of government and the high tax burden in this country, it is an article of faith to Mr Anderton and Ms Coney that big government can be made smarter and that we would do better with even bigger government. They seem to have learned nothing from the collapse of the centrally planned economies and the failure of the welfare states of Europe.

To anyone remotely familiar with the rest of the world, the economic changes in New Zealand over the past 15 years should have come as no surprise. No Western country had carried state intervention in the economy and cradle-to-grave welfare anywhere near as far as New Zealand. Over the past 20 years, every country in the Organisation for Economic Cooperation and Development (OECD) without exception, and many others besides, have been moving in the direction of deregulation, privatisation and generally greater economic freedom. Anyone who has spent time in Australia, the United States, Britain, Asia and even Europe has seen these developments with their own eyes.

Recently there have been a number of articles in newspapers reflecting on 15 years of economic change in New Zealand since July 1984. Some commentators have tried to persuade us that the reforms have failed. They play games like lumping in the years of restructuring in the 1980s, when the economy barely grew, with the subsequent period of expansion during the 1990s and telling us that the average growth rate over the period has not been much better than in earlier years. This is like saying that Russia and the Eastern European countries were wrong to embark on a transition to a market economy because measured output in all of them initially slumped – in Russia's case by around 50 percent – and in some other cases has still not recovered to previous levels. But these same commentators are getting a hearing because there is a vacuum of leadership putting the issues in perspective, and because New Zealand's level of understanding about the realities of international economic success still has a long way to go.

The fact is that when a consistent economic framework was finally put in place in New Zealand in the early 1990s, the economy grew strongly and practically all other indicators – inflation, unemployment, the fiscal position and our credit rating – improved significantly. Over the four years 1993–1996, the economy averaged 4 percent growth and we outperformed Australia. Over the decade as a whole the trend rate of growth has been roughly 3 percent and the economy looks likely to grow at about that rate in the next few years. This is respectable by international standards and a far better performance than we were previously capable of achieving.

But having said this, the further point to make is that we have lost our way badly over the past two parliamentary terms and the country is suffering as a direct result. Looking back, we can now see that New Zealand was really serious about economic reform for only about five of the past 15 years – under the Labour government from 1984 to early 1988 and during the first 18 months of the National government which came into office in 1990. For the rest of the time, progress has only occurred in fits and starts, and in key areas we have gone backwards.

What are those areas? The big setbacks since 1993 are not hard to recognise – the blow-out in government spending, the growth of costly new regulations, the move to the Mixed Member Proportional (MMP) voting system, and the failure to press on with necessary reforms. Cumulatively they have set the country back enormously.

By the end of the 1999/2000 financial year, National will have boosted government spending by some $6 billion. This is a spending programme of Think Big proportions. It has drained resources from the private sector into many low quality and unnecessary public sector activities. According to the OECD, total spending by governments in New Zealand (including local government) is back up to around 41.5 percent of gross domestic product (GDP). By contrast, total spending in Australia, itself a hugely over-governed country, is currently running at 33.6 percent of GDP and the OECD projects that by 2001 this percentage will have come down in seven out of eight successive years. This is a major factor in Australia's strong performance. A country with two-fifths of its national income being channelled through the government sector is not going to do well.

On the regulatory front, reregulation rather than deregulation has been the order of the day. We are smothering the productive people of this country with red tape and bureaucracy. In the past decade alone, parliament has passed over 5,200 new laws and regulations – Hong Kong has some 1,000 regulations in total affecting the business sector. Gary Paykel, chief executive of Fisher and Paykel – and hardly a supporter of the earlier deregulatory thrust – recently recited a list of regulations that imposed major costs on his business. They included the Privacy Act 1993, the Commerce Act 1986, the Fair Trading Act 1986, the Hazardous Substances and New Organisms Act 1996, the Human Rights Act 1993, the Resource Management Act 1991, the Employment Contracts Act 1991 and the Securities Act 1978. Almost all these regulations have been enacted in the 1990s. All of them add to the costs of small and large businesses alike. The Employers Federation reports that a medium-sized firm can expect to have to complete 168 government forms each year. Like Germany after the Second World War, we need a bonfire of regulations.

MMP has worked out more or less as many of us predicted. It is a less transparent, less accountable and less democratic system, and has brought politics to new lows. The public thought MMP would give it greater control over politicians; in fact it has got less and it is now thoroughly dissatisfied. As expected, MMP has led to paralysis and low quality compromise in decision making. Longer experience with the system will not improve it. The country must be given the opportunity to vote again on MMP in the next parliamentary term.

And as a result of New Zealand's policy inertia and paralysis in recent years, it has fallen well behind the rate of progress many other countries are making. When we were doing outstanding things, people overseas noticed, visited and copied New Zealand. No longer do others look to New Zealand as a leader in economic reform. In the latest IMD survey of international competitiveness we have fallen to twentieth position. In areas like privatisation, infrastructure provision, education and welfare reform, other countries are showing the way. New Zealand has failed to develop the kind of consensus and culture that characterises successful countries – the United States, for example, where there are no great lurches of policy whenever a Republican administration replaces a Democratic one, or vice versa. We have extricated ourselves from basket case status, but we now look just ordinary compared with more ambitious countries.

The community clearly recognises that New Zealand is underperforming. In the first half of the 1990s there was a new sense of optimism and excitement about New Zealand. It was attracting interest around the world, major international companies were investing in the country, scarcely a week went by without reports of Australian firms relocating here, and there was a big inflow of talented people, including New Zealanders returning from abroad. Today those trends have reversed, most worryingly in the form of a big outflow of skilled and enterprising New Zealanders. We have developed a cottage industry of pessimism. There has seldom been a more pervasive negative sentiment in the business community. Most business people I know who have made money have redirected much of their investment offshore, for perfectly understandable reasons. The national hangdog mood is wearing down even the most resilient and patriotic spirits.

Why is all this happening? Clearly the economic mismanagement and stop/go progress of recent years has taken its toll. But we also have to look deeper and ask why governments, which ultimately reflect community attitudes and pressures, have behaved the way they have. Why is there an attachment, for example, to the kind of policies that Labour is promoting today – contrary to their hugely creditable record in the 1980s – when no leading country in the world is looking in the same direction? Why is National offering no vision and agenda as it goes into the election?

One answer is that the habit of seeking favours from governments is far from dead. We see this every day for example, in the form of health, education, pensioner and environmental lobbies, , seeking additional spending or regulations whose costs fall on other people. The lobbyists' arguments resonate widely with many people who still see government as benign and associate it with compassion, despite its repeated failures to deliver. Even some in the business sector as well as some politicians have shown a tendency to revert to old ways and argue for subsidies and tax breaks for things like venture capital, research and development and accelerated depreciation. They tell us, of course, that they are not into 'picking winners' but that is exactly what such policies involve: a benefit to help one industry grow is inevitably a cost to some other industry which will make it less profitable. In the process, government spending and tax rates rise.

To be sure, some other countries like those which came to grief in Asia engage in such policies, but that is no reason for us to copy their foolishness. If industry interventions were the route to economic salvation, New Zealand would have been a star performer in the past because we applied them in huge doses. Ireland had subsidies for years but its economy stagnated; only when it took to monetary and fiscal discipline and general liberalisation did its economy take off. As part of its business tax reforms, there is a push in Australia to get rid of tax concessions such as accelerated depreciation and to lower company tax rates instead. The business sector in New Zealand would do far better to urge New Zealand governments to do likewise rather than go back down a path of government handouts and favours. The New Zealand government could do more to push Australia to eliminate Closer Economic Relations (CER) distortions and barriers to trade – we often seem limp-wristed in our trans-Tasman diplomacy.

In the business sector, I do not believe that proposals to return to failed policies will go very far – most producers in the economy are strongly committed to the new environment. Contrary to the proponents of past failed policies, the success of countries like the United States, Australia and the top performers in Europe and Asia is not built on selective industry interventions – if anything, they have held these countries back. Rather, their success is due to much the same kind of policies New Zealand embarked upon, involving greater economic freedom and government restraint. Does anyone really want to put our current generation of politicians and bureaucrats in charge of commercial decision making in this country?

But outside the business sector, the country is having enormous difficulty shaking off what the *Australian Financial Review* once described as "the clammy grip still reaching out from the socialist grave – pulling New Zealand back into its welfarist, isolationist roots". The urge to focus on redistributing wealth rather than creating it is still strong. It is bedevilling the advancement of the Maori community. New Zealanders still tend to see issues in a vacuum, isolated from national and international realities. We hang on to things that are no longer relevant like car assembly operations and producer boards. We focus on the trivial and on personalities and symbols rather than debate substantive ideas. We lack international benchmarks for deciding what works. We think that the sharemarket is languishing because of poor regulation when the problem is a poor business and economic environment. We look for desperate solutions like joining Australia and becoming another Tasmania. We blame governments not ourselves for our problems.

There is much that I like about New Zealand's egalitarian culture. We have never been a class-ridden society. But unlike in the United States, this has not translated into an easy openness to new ideas and a strong sense of national confidence and cohesion. And our culture has its toxic sides, such as when children deride their classmates for getting ahead, and in our tendency to be knockers. As John Hewson, the former leader of the Liberal Party in Australia, recently wrote, speaking of tendencies in Australia that are less damaging than ours:

> While this has been a strength of the Australian character – we haven't taken ourselves, or each other, too seriously and we have been justifiably sceptical of new guys with new ideas – it disturbingly has also worked to hold people back, to choke originality and entrepreneurship. And to simply fail to give credit where credit is due.
>
> During my time in the United States, by comparison, I was impressed by the American nationalistic spirit, their unequalled capacity to find the good in people or events and to be uplifting rather than downgrading. It didn't matter who you were, or what you had done, but your small successes were made big and your failures were minimised or overlooked.

The United States is the stand-out economy of the 1990s – countries like Canada and the United Kingdom are trying to learn the lessons of its entrepreneurial success.

Another feature of New Zealand's egalitarian culture that I like is our instinctive concern for the underprivileged and people down on their luck. But too much of this culture has been deformed by state welfare which has made many problems worse. To be practical, compassion has to take the form of giving people fair chances, supporting them in need, but not turning them into dependents. By far the best way for governments to help the poor is to maintain order, create the conditions for prosperity and encourage self-reliance – and all these things require a certain hard-headedness. A soft heart is fine, but soft-headed policies are a recipe for disaster. Again the welfare reforms in the United States in recent years, are showing us the way to go. They have helped shift that economy close to full employment, and slashed welfare rolls dramatically – by 90 percent in Wisconsin in the past decade.

I conclude that New Zealand needs a loud wake-up call. The way we are going the whole country will soon be on Prozac. What is the way ahead?

First, I suggest we should have no lack of confidence in the general path the country has taken. The reforms were delivering major gains in the mid-1990s and we are still doing better than we were. But progress has stalled. The combination of Jim Bolger's teabreak, Winston Peters' economic ineptitude and MMP have been huge setbacks from which we have not recovered. At the beginning of this year the prime minister announced that the government would complete work in this parliamentary term on the review of the Resource Management Act 1991 and deal with the rating powers of local government, roading, water and tertiary education. It will deliver on none of these. No business could survive today with such a decision-making work rate. We are pointed in the right direction but we need more traction and consistency. Some people dislike this insistence on the necessity of a sound fundamental strategy and they look for novelty and short-cuts. But how can advocacy of a proven recipe for success be boring and irrelevant?

Secondly, the way forward has to involve far less reliance on government. The recent New Zealand Study of Values found that only 16 percent of those surveyed had a great deal of confidence or quite a lot of confidence in government, down from 48 percent in 1985. The same trends are evident worldwide. We have asked governments to get involved in activities far beyond their proper roles and we must rely more on individual choice and initiative, through both the commercial and the voluntary sectors. New Zealand has neither the financial nor the human resources to run big government operations. We have seen the huge benefits of the partial opening up of ACC to competition. Think of the gains we would get from removing the state monopolies in health, education and welfare.

Finally, we must decide how we are going to be motivated to make changes. As I see it, there are only two possibilities: crisis on the one hand or leadership and vision on the other. In 1984 we had both an economic crisis that precipitated change and political leadership that the country supported in the 1987 election. A few more years of large current account deficits, growing external debt and outflows of people and capital could return us to a crisis situation. Investment markets are already notching up the risk premium on New Zealand as the election approaches. Do we always have to learn the hard way?

The alternative is to stop blaming governments and each other and to determine through leadership that we want to do better. Why do we not, for example, decide that within the next few years we want to see:

- full employment levels like those in the United States;
- education standards like those in Asian countries which top international comparisons;
- welfare rolls back to the levels of the early 1970s;
- older people and the general population feeling safe in their homes and on the streets;
- equal levels of productivity and incomes to those in Australia – a perfectly attainable objective within, say, 10 years;

- low tax rates that attract businesses and investment from around the world;
- young New Zealanders eager to return to careers at home after working abroad; and
- people in our media and universities who have been citizens of the world and who can help the community confront the challenges and opportunities of the twenty-first century.

All of these things are possible. There is nothing wrong with New Zealanders' genes. New Zealanders are perfectly competent in doing business, and the economy is wide open to anyone who thinks they can do better. Everything depends on how well we run our national affairs. We simply have to stop shooting ourselves in the foot. As Bob Hawke said about MMP, New Zealanders thought they were punishing politicians but in fact they were punishing themselves. That goes for too many of our national reactions. We have to raise our sights and look at the wider picture.

Going into the next millennium, New Zealand should be an optimistic place. Growth is picking up internationally, most countries are continuing to move towards better economic policies, tensions between nations are easing and the world isn't running out of resources to support higher living standards. It's time we broke out of our insularity, knocked the knockers and got on with the job of creating a first-class country. And 'we' means not just politicians but all of us.

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# IS NEW ZEALAND ON THE RIGHT TRACK OR THE WRONG TRACK?

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**HAMILTON**
**20 JULY 1999**

# IS NEW ZEALAND ON THE RIGHT TRACK OR THE WRONG TRACK?

Every couple of months, for many years, the *National Business Review* (*NBR*) has published the results of a poll which asks the question: "Generally speaking, are things in New Zealand heading in the right direction or are they off on the wrong track?".

I think the poll results are a very interesting indicator, and I understand it is watched closely by politicians. What does it tell us about the public's perceptions of the country's directions over the past five years?

If we go back to mid-1994, we find that a substantial majority of people thought New Zealand was on the right track. In both May and July of that year, 60 percent said New Zealand was going in the right direction compared with 27 percent who said it was not (13 percent were unsure).

The year 1994 marked a decade of economic reforms in New Zealand. The economy grew that year by 6 percent, having grown by 5 percent the previous year. Unemployment was falling sharply, inflation was low, the current account deficit was around 1 percent of gross domestic product (GDP), and the budget was in surplus. The reforms were paying substantial dividends.

But 1994 was also the year in which the Bolger government, shaken by the 1993 election result, dropped the ball. It called a halt to any serious efforts to continue to strengthen the economy and New Zealand's competitive position. It started to increase government spending substantially, and the fiscal incontinence of the subsequent coalition government has seen the budget surplus all but disappear. In recent years, as the Organisation for Economic Cooperation and Development (OECD) pointed out in its recent report on New Zealand, efforts to move ahead with other necessary reforms have been "stop-and-go". There has been far more talk than action.

The failure to maintain a coherent, medium-term strategy for economic growth since the early 1990s has resulted in a deteriorating economic performance. The economy recorded negative economic growth in the year to March 1999, and is now in only a moderate recovery phase. Unemployment has risen from its 1996 lows, the current account deficit is at a worrying level, and external debt is around 100 percent of GDP, a high ratio by international standards. New Zealand has fallen back to twentieth position in the IMD rankings of international competitiveness due to two parliamentary terms of economic mismanagement. It is hardly surprising that the export sector is weak and the economy as a whole is struggling.

How has the public reacted to this loss of momentum and direction? In my interpretation, very intelligently. The number of people who think New Zealand is on the right track has fallen steadily since the mid-1990s, although there have been fluctuations along the way. In the latest *NBR* poll, 49 percent think New Zealand is on the wrong track compared with 41 percent who think it is heading in the right direction. Until the recent recovery, the 'wrong track' numbers were even higher.

Within these trends, it is interesting to note that younger people have been generally positive about the country's directions and people over 60 have been more pessimistic. Much of the criticism of the changes in New Zealand since 1984 has come from the older generation. It is a widely observed phenomenon that the younger generation tends to favour change, even if it inflicts short-term cost, provided it offers the prospect of longer-term yields. The old tend to resist change. If you read letters to the editor columns for a few months you can work out that a few dozen people 60 years of age or over write all the time lamenting the changes and expressing nostalgia for the past. The recurring sentiments are anti-trade, anti-foreign investment, anti-privatisation, anti-immigration and anti-wealth. The Alliance and, until recent times, New Zealand First have received disproportionate support from this group.

You can see very much the same pattern of reactions internationally. In Australia it has taken the form of a backlash against so-called 'economic rationalism' and support for Pauline Hanson's party One Nation. In Britain the older generation has never come to terms with the Thatcher revolution. And in Russia and the ex-communist countries of eastern Europe there is deep resentment among many of the older people about the moves to a market economy and support for ex-communist and nationalist parties.

On the other hand, the attitudes of younger people in New Zealand are mirrored among younger people elsewhere. A recent article in the *Spectator* reported the prevailing attitudes in Britain among Generation X (those born in the 1970s) in the following terms:

> Generation X favours a society where the state's role is significantly smaller than it is today. For young people government is not part of the solution but is part of the problem. ... [T]he emphasis is on individual responsibility, economic liberty and social freedom.

The article gave as an example of changed attitudes the views on student fees in Britain. It said:

> The apathy over the introduction of student fees proved that the days of marches are over. In fact, fees are a welcome move for many. Students have become customers with bargaining power, more able to demand improved academic facilities and student services.

And the article went on to report evidence that "A striking 51 per cent desire to own their own businesses, reflecting a move away from the 'jobs for life' mentality of the past". Taxes and regulation were seen as barriers to success and deterrents to innovation, hard work and enterprise. It concluded with the comment: "The challenge for the rest of society is whether it continues to alienate its young people or sits up and listens to them".

A similar debate is going on in New Zealand. Last year Douglas Myers, speaking on behalf of the New Zealand Business Roundtable, referred to the kind of arguments about New Zealand's direction that can be heard at any Grey Power rally, noting that "Many of the same generation that ran New Zealand into the ground by the early 1980s push an agenda that would do the same again". This drew a response in the form of an article 'The Roundtable is wrong' by Don Robertson, president of Grey Power, in that organisation's magazine. Let me address his arguments to see where we disagree, and also where we may have some common ground.

The article led off with a couple of frequently heard criticisms about New Zealand's reforms. It claimed that the economic pain had been felt by most New Zealanders but the gains had accrued to only a few. It was perhaps rather unfortunate for Don Robertson's argument that his article appeared on the same page as a large advertisement for a 7-day 'Tropic Treat' holiday in Queensland. Presumably at least some members of Grey Power have enjoyed some of the gains.

The idea that the gains have only gone to a fortunate few is a gross overstatement. To be sure, the recent Statistics New Zealand study *New Zealand Now: Incomes* (February 1999) confirmed that there has been a premium for skills in the new economy and that increases in household incomes have been greatest in the top deciles. But it also confirmed that there was no fall in the share of income of low income households. It also has to be remembered that a significant part of the gains from economic growth went to repaying public debt, which is a genuine benefit to the whole community, and to higher spending on health and education, sometimes called the social wage. Average weekly earnings have risen from

$564 in May 1991 to $682 in February 1999. Low income earners have benefited from two rounds of tax reductions, and most households have benefited from cheaper imported products, including cars. Grey Power should examine the facts more dispassionately. I can agree with Don Robertson, however, that the overall gains are not as large as they would have been had New Zealand maintained the rate of progress it was making up to the mid-1990s, and as large as they could be if the economy were operating at its true potential.

Secondly, the article complained about the 'market model' that New Zealand has adopted and argues for a "more people orientated approach". We might begin by asking what country has not been moving in a more market-oriented direction in the past 15 years, apart from a handful like Cuba and North Korea. Furthermore, no one who has argued for more reliance on markets denies there is an important role for governments. Indeed we might agree with Grey Power that by getting involved in far too many functions, governments have been performing some of their core roles badly, such as not giving older people the security they deserve in their homes. And on the people issue, I share the reactions of the Australian columnist Ross Gittens who wrote recently in the *Sydney Morning Herald*:

> It always annoys me to hear people saying we worry too much about the Economy and not enough about People. It's as though they imagine there's this utterly impersonal thing called the economy on one side, and all the people on the other.
>
> But the economy is us. No people, no economy. An American economist of the '60s, Herbert Stein, said: "[gross national product] (GNP) is what ensues when 100 million people get up in the morning and go to work."
>
> The economy is no more than the business of producing and consuming goods and services. All of us work in that business.

Gittens might have added that those who profess to be concerned about people, and in particular about those in hardship, ought to take an interest in how to grow community wealth.

I expected the rest of Don Roberston's article would lay out an alternative agenda to what he calls the 'market model', but I was disappointed. The only significant themes are that we should give more tariff protection to our industries and that we should be more like Australia in our economic policies.

On tariff protection Grey Power has clearly still not come to terms with the fact that fortress New Zealand and fortress Australia policies caused both our countries to fall well down the per capita income tables over the past 50 years. Australia started to dismantle its protective walls much earlier than New Zealand. It abandoned most import licensing in the 1960s, and Gough Whitlam's Labor government cut tariffs by 25 percent in 1973. More recently Australia has been reducing tariffs at a similar rate to New Zealand, and the two countries' tariff structures are currently very similar. New Zealand is removing all its tariffs by 2006 and Australia is committed to full free trade by 2010. Hardly a big difference here.

Both New Zealand and Australian governments have long since realised that protection does nothing for job creation, contrary to the views of Grey Power. By raising costs it makes other industries, particularly export industries, less competitive and less able to create jobs. By misallocating resources into industries that are only profitable with protection and away from industries that can stand on their own feet, protection undermines economic growth and makes jobs harder to create. Since 1991 more than quarter of a million net additional jobs have been created in New Zealand, far offsetting those lost through closures in industries such as motor vehicles and clothing. Grey Power's policies would reduce economic growth and see many more New Zealanders out of work.

Its concerns about employment should instead be focused on policies for economic growth and for making the labour market work better.

Australia has been following very similar policies to New Zealand on trade, but has it been following different policies in other areas? Generally speaking, the answer is an overwhelming 'no'. Australia began some of its reforms earlier than New Zealand. It did not face an economic crisis as New Zealand did in 1984, and therefore did not have to undertake such drastic restructuring. But looking at the two countries over the past 15 years, what stands out today is, first, the similarities in the two reform programmes and, secondly, the fact that Australia is now ahead of New Zealand on many fronts.

Consider a short list of key policies:

- Australia and New Zealand are following almost identical monetary policies and have both achieved low inflation.
- Both countries have floating exchange rates and almost fully deregulated financial systems.
- Australia has a budget surplus whereas New Zealand is struggling to restore one.
- Australia has much lower government expenditure relative to GDP than New Zealand – 32.6 percent this year at all levels of government compared with 41.5 percent in New Zealand.
- Australia has moved its tax system in much the same direction as New Zealand, and has now adopted a goods and services tax (GST).
- Australia has been one of the world's leading privatisers in recent years whereas New Zealand has made slow progress in this area.
- It has done more to deregulate and corporatise its agricultural marketing authorities than New Zealand.
- In infrastructure such as electricity, water and roading Australia is well ahead of New Zealand in adopting commercial models and moving towards private sector provision. Australia has privatised all of its main airports except Sydney.
- Spending on welfare and pensions is lower in Australia than in New Zealand. Australia has an income and assets tested pension scheme.
- New Zealand is ahead of Australia in achieving a decentralised, enterprise-focused labour market, but Australia is catching up. It has abandoned centralised incomes policies and is making substantial progress in former industrial relations black spots like the waterfront.
- Most observers agree that Australia has a better education system than New Zealand, at both the school and university levels. About 30 percent of Australian children go to private schools and the government is pushing for more competition and choice, whereas the New Zealand government has, with the integration of most private schools, increased its monopoly of education.

This list indicates that Don Robertson's claim that Australia has been on a different track from New Zealand is clearly wrong. Australia has done virtually all that New Zealand has done and more. It has kept on keeping on rather than engaged in stop-go reforms. After its period of serious reforms New Zealand was performing better than Australia in the mid-1990s but the roles have now been reversed. Australia was sixteenth in the IMD world competitiveness rankings in 1995 when New Zealand occupied the ninth spot, but is now in twelfth position compared with New Zealand's twentieth. The price New Zealand has paid for the economic mismanagement of recent years is that we had a much less resilient economy when the Asian crisis hit us and a poorer outlook than Australia in the medium-term future.

Don Robertson ended his article by saying "Grey Power advocates a return to the past only in the sense that there is a need to return to a fair and equitable society". I share his concerns for fairness and I agree there are aspects of a fair and compassionate society that we have lost. For example, I believe state welfare has crowded out many forms of family and voluntary welfare with worse results. Old New Zealand was characterised by values like self-reliance, independence and thrift that deserve our respect. I also believe that labour legislation up to the 1970s, which gave wide freedoms to workers to quit unsatisfactory jobs and employers to fire unsatisfactory or redundant workers, contributed to full employment, and thereby provided both employers and employees with greater protection against injustice than the cumbersome regulations in place today.

At the same time, however, old New Zealand was characterised by far more social and economic privilege than is the case today, as well as more repressive attitudes towards women, and towards Maori and other minority groups. Twenty years ago married women could not get a loan from a bank unless it was guaranteed by a man. There was also a great deal of slackness and many lazy work habits, most famously symbolised by the seagull on the wharf and the Ministry of Works roadman leaning on a shovel. In a recent letter to *The Press* a 1950s Dutch immigrant reported a common experience of the time – New Zealand 'workers' complained that he worked too hard. And I strongly disagree with Don Robertson's implied suggestion that interventionist economies score more highly on the grounds of equality. As Milton Friedman explained in *Free to Choose*:

> In the past century a myth has grown up that free market capitalism – equality of opportunity as we have interpreted that term – increases ... inequalities, that it is a system under which the rich exploit the poor.
>
> Nothing could be further from the truth. Wherever the free market has been permitted to operate, wherever anything approaching equality of opportunity has existed, the ordinary man has been able to attain levels of living never dreamed of before. Nowhere is the gap between rich and poor wider, nowhere are the rich richer and the poor poorer, than in those societies that do not permit the free market to operate. That is true of feudal societies like medieval Europe, India before independence, and much of modern South America where inherited status determines position. It is equally true of centrally planned societies, like Russia or China or India since independence, where access to government determines position. It is true even where central planning was introduced, as in all three of these countries, in the name of equality.

I conclude, therefore, that a good deal of Grey Power's thinking is misplaced and outmoded, and that the organisation would do well to consult mainstream economic sources and experts and update its policies. It should also listen to what the younger generation here and around the world is saying and doing about its aspirations and desires – a disturbing number of skilled and entrepreneurial people are currently leaving this country. And it should make common cause with other organisations that have gone through similar disciplines in framing their policies. The Business Roundtable has been pleased to work with like-minded groups, and indeed have been involved with Grey Power in Christchurch on submissions on local government in that city.

Certainly Grey Power should take that approach if, as Don Robertson says, "Our main concern is for the future for our children and for our children's children". That has not been the consistent track record of his age group, as David Thomson documented in his book *Selfish Generations?*. He showed that what he called the "welfare generation" – those born between 1920 and 1945 – drew far more from the common pool than they contributed. They left a legacy of debt for the next generation to repay. The next generation – and I daresay I am one of them – has had to repay that debt as well as pay through taxes for the pensions of those in retirement that were never funded, plan for their own superannuation, pay some of the costs of their children's higher education, and much more. I for one have accepted that outcome, in the belief that there was no other way to reconstruct a viable New Zealand.

Whether members of the retired generation genuinely have the interests of the country at heart or are just concerned about their own interests, I suggest they should be strong advocates of policies that can make New Zealand a dynamic, vibrant economy. The only way any generation will achieve income security in old age is through economic growth. I support the concept of a social safety net, but no level of state-funded superannuation can be guaranteed in a stagnant economy. The lessons of how to achieve modern economic growth are well established. If all groups could study and embrace them, I believe there would be a stronger political constituency for progress in this country and less divisiveness between groups who should share common interests. New Zealand was on the right track in the second half of the 1980s and early 1990s, it has departed from it to its cost, and it needs to get back on track again.

**1999 MAJOR AND MULTI STORES CONFERENCE**

# THE RETAIL SECTOR AND THE ECONOMY

ROGER KERR
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AUCKLAND
31 MAY 1999

# THE RETAIL SECTOR AND THE ECONOMY

The 1999 budget delivered mid-May confirmed that the New Zealand economy is on an improving path. Over the next three years, annual growth is likely to run at around 3 percent, according to the government's projections. They are not out of line with the consensus among economic forecasters.

For the retail sector, the improved outlook is good news. Consumer spending was flat in the first half of 1998, picking up in the second half of the year. It was supported by the July 1998 tax cuts and the reductions in motor vehicle tariffs. Consumer confidence has risen and the current low levels of interest rates are expected to buoy consumption growth. Offsetting factors include net outward migration and relatively high levels of household debt. Overall, private consumption growth is projected to average around 2.5 percent per annum and residential investment growth around twice that rate over the next three years. Tourism growth is projected to rise to an annual rate of around 9 percent over the next two years.

I believe this improved outlook is due in part to more stable and somewhat improved policy directions over the past 12 months. Winston Peters had commendable ambitions for the economy, but regrettably he was a disaster as treasurer. He never achieved credibility in the eyes of the business community; it was impossible to convince overseas investors and business people that he understood how the economy worked. His $5 billion of additional government spending by itself killed any hopes that the economy would pick up during the term of the coalition government.

The somewhat firmer fiscal stance adopted by the government over the past 12 months has clearly been beneficial. In total its spending plans have been reduced by some $800 million. It is regrettable that the government's fiscal policy decisions have not been bolder and more consistent. Only six months ago (in the 1999 Budget Policy Statement) it was telling us 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.

However, I am not aware that the short-term fiscal balance was the focus of any proposals for expenditure reductions. What critics of the government's fiscal strategy were saying was that it should be implementing 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.

In the May 1999 budget, the government has moved to a somewhat firmer stance. It is now saying it is putting a cap on new policy initiatives of $600 million in 2000/01 and a further $600 million in 2001/02, and that these initiatives could include tax reductions as well as new spending. But the question still arises as to why the government has not set out plans over the next couple of years to undo more of New Zealand First's enormously damaging $5 billion package of generally low quality spending.

In a report, *Moving into the Fast Lane*, published prior to the last election, the New Zealand Business Roundtable, in association with the Auckland and Wellington chambers of commerce, outlined a programme for further improving New Zealand's economic performance. As well as making some progress on fiscal policy, the government has taken other important decisions over the past 12 months that are consistent with the advice in that report. They include:

- the decision to phase out all tariffs, albeit on a rather extended timetable;
- some privatisation initiatives, in particular the sale of its shareholdings in the Auckland and Wellington airport companies and the sale of Contact Energy;
- the reduction in the rate of New Zealand Superannuation to a more realistic level;
- the partial opening up of the Accident Rehabilitation and Compensation Insurance Corporation (ACC) scheme to competition, and
- progress on reform of producer boards, roading, water and sewerage and the Resource Management Act 1991, although decision making on all these issues is painfully slow.

These developments have contributed to the quite rapid turnaround in the economy following the recession in the first half of 1998. The robustness of the economy also owes much to the greatly improved economic framework put in place by governments over the past 15 years. The fall in unemployment, for example, testifies to the benefits of the more flexible labour market, despite the efforts of the Employment Court to undo the benefits of the Employment Contracts Act 1991.

But we need to retain a sense of perspective. As the events of the past year demonstrate, the economic outlook can change quite rapidly. In last year's budget the government was projecting economic growth of 2.7 percent in the year to March 1999; now it is estimating that the economy shrank by 0.3 percent in that period. There is always the potential for unpleasant economic surprises, as events such as sharemarket falls, wars in the Gulf and Kosovo, droughts, floods, electricity crises and the Asian economic turmoil should remind us. Equally, the short-term outlook could turn out to be better than forecast, helped by improving world growth and price improvements for some commodities.

In a medium-term context, moreover, two things should worry us about the economy's growth path. One is that the present recovery is being largely driven by growth in consumption and housing investment. The second is that New Zealand is still massively underperforming relative to its potential.

Clearly the easing of monetary policy over the past couple of years and the current low interest rates are boosting domestic demand. But despite the large fall in the exchange rate over the same period, export growth prospects are only modest. Unlike the 1991 economic recovery, this one is not being led by strong export and investment growth.

It follows that a clear risk to the recovery is the weak balance of payments situation. Over the next three years, the current account deficit is projected to stay around 6 percent of gross domestic product (GDP); in the four years from 1991 to 1994 inclusive it averaged around 2 percent. New Zealand's external debt, at around 100 percent of GDP, is already the highest in the Organisation for Economic Cooperation and Development (OECD). In the event of further shocks to the economy, political uncertainty or a deterioration in policies, New Zealand is clearly vulnerable to a further credit rating downgrade and a loss of investor confidence.

Similarly, although the long-run performance of the economy has improved, it clearly remains well below its potential. In the recent budget, the government made the point that over the decade to 2002, the economy is expected to grow by an average of 3 percent a year, three times faster than in the previous decade. On this basis the economy in 2002 will be a third larger than it was in 1992. But this comparison is very sensitive to the precise time period chosen. For example, for the 10 years 1990–1999 inclusive, cumulative growth is likely to be a little over 23 percent compared with around 20 percent in 1980–89 and 25.5 percent in 1970–1979. Given other achievements such as the virtual elimination of inflation and large reductions in net public debt, there has been major progress in the past decade, but it is hardly a stellar performance.

The unpalatable truth is that New Zealand has lost ground again in recent years, relative to its achievements in the early and mid 1990s. The big gains in terms of growth in productivity and output, falling unemployment, substantial fiscal surpluses and low inflation followed the 1991 budget and the Employment Contracts Act 1991. Had we maintained that performance, unemployment could have been around 4 percent by now instead of over 7 percent. Equally, we could have achieved a triple A credit rating instead of suffering a credit rating downgrade. In 1995 New Zealand was in eighth position in rankings of international competitiveness; this year we are in twentieth position, below the ranking of eighteenth position we held in 1991. Many governments have pressed on with efforts to improve their economies while we have slid backwards.

The competitiveness story is important because of New Zealand's large current account deficit and external liabilities, and because the New Zealand economy never performs well for very long unless the export sector is in good shape. The retail sector has as large a stake as the community in general in a strong export performance; in the long run exports are required to pay for imports.

What might be done to strengthen New Zealand's external position? We can consider this question in three different ways.

First, during the present recovery the government needs to implement more consistent macroeconomic policies. Monetary policy must be kept firm to avoid excessive domestic demand spilling over into imports. Government spending must be curbed so that the Reserve Bank is not forced unnecessarily to raise interest rates to restrain cost increases in the non-traded goods sector of the economy.

Secondly, many steps should be taken to reduce domestic costs and promote innovation in our export industries. These include further privatisation at both central and local government levels, more commercial approaches to the provision of infrastructure such as water and roading, full deregulation of remaining monopolies such as the ACC and producer boards, reform of the Resource Management Act 1991, and changes to the Employment Contracts Act 1991 to overturn the job-destroying rulings of the Employment Court.

Thirdly, the current account deficit is the difference between national savings and national investment. Measures that would be positive for national savings include larger operating surpluses, reductions in income taxes and more targeted approaches to welfare and superannuation arrangements.

The important point to make about all these measures is that they would be positive for economic performance generally as well as for the balance of payments position. Economists rightly point out that the balance of payments should not be an economic goal in its own right, particularly when it is determined primarily by private investment, lending and borrowing decisions and not by the government accumulating external liabilities. However, the present external position poses risks, and vigorous efforts should be made to improve it, especially since these efforts would be conducive to a better growth performance as well.

Improvements in economic management relative to New Zealand's record in recent years are more important overall for the retail industry than specific measures affecting your own sector. However, four current issues are worth mentioning briefly because they would benefit retailers and the community at large.

The first is the bill proposing further deregulation of shop trading hours. Despite strong opposition at the time, the changes made in 1990 turned out to be hugely popular and brought New Zealand into the modern world. Who would now propose a return to the old regime? Most of the remaining restrictions are absurd, and they should go.

Secondly, parliament is considering further liberalisation of the Sale of Liquor Act 1989. Again the most recent changes have proved highly successful, and they should be taken further. Vested interests in the liquor retailing industry should be ignored. Opponents of liberalisation do not have the moral high ground: the same groups gave us 6 o'clock closing, which made New Zealand about the least civilised nation of drinkers on earth. I lived for four years in Belgium which has liberal drinking laws and no minimum legal drinking age at all, and Belgian attitudes towards alcohol are more mature and responsible than our own, in my view, despite our recent improvements. Beer, wine and spirits were available in supermarkets seven days a week in Belgium at least as long ago as 1970. With shop trading hours and liquor retailing, it is high time New Zealand shook off the last remnants of its repressive past.

Thirdly, I am aware that some major stores want to be able to operate pharmacies. This would be a convenient service for shoppers, and in all probability cut costs to consumers as well. Liberalisation of pharmacy ownership has been talked about for more than 10 years, but nothing has happened. New Zealand stands out as a country maintaining absurd restrictions on pharmacies, and also on optical dispensing, and it is disgraceful that governments have continued to bow to the self-serving lobbying of interests that would be threatened by deregulation.

Fourthly, the retail industry should be supporting deregulation of producer boards, especially the Dairy Board, in the interests of the economy in general but also for the benefit of domestic consumers of milk. It is well known that dairy companies enjoy fat margins on sales of milk and other fresh products on the local market. A study published by the New Zealand Business Roundtable in 1998 concluded that New Zealand consumers may be paying about $100 million extra a year for dairy products. True to form, the Consumers' Institute has maintained a resounding silence on this issue, just as it has been on the wrong side of practically every other argument for greater competition over the past 15 years. The government should fully deregulate the dairy industry and spoil the industry's party, and the retail trade should be lending it its full support.

Finally, I was asked to say a word on the implications for the retail sector of a change of government following this year's election. What matters most for business, of course, is not so much whether the government changes but whether policies affecting the business sector change for better or for worse.

Labour and the Alliance, the most likely alternative coalition government, have not yet released all their election policies. On present indications, however, it is hard to identify Labour policies that would be positive for economic growth, and Alliance policies would be much worse. The most important point about Labour's policy to increase the top personal tax rate is that it wants to increase government spending over and above the already massive and damaging increases of recent years. Even so, the tax increase would not fund Labour's spending proposals. It would also, of course, worsen the distortions in the income tax system and accelerate the already disturbing outflow of skilled people and capital from New Zealand.

Other policy positions are equally worrying. Dick Hubbard told the Labour Party at its recent (1999) conference that changes to the Employment Contracts Act 1991 were acceptable provided they were not "anti-business". This is naive: the changes being promoted are explicitly pro-union and against the interests not just of business but of workers and the unemployed as well. Labour's current policy commitments also include an end to privatisation, a reversal of the ACC reforms, and increased expenditure on pensions and welfare programmes, all of which would be harmful for business and the economy.

Michael Cullen is reported to have fought "bitterly" against the tax rate increase, and it is to be hoped that some of Labour's policies may yet be reconsidered. Certainly its current economic ideas bear little resemblance to what the OECD recommended for New Zealand in its report in early May. The main weak features of the economic framework of the Labour government in the 1980s were a lack of fiscal discipline and an attachment to a regulated labour market. There is clearly a risk, as Yogi Berra would put it, that the country faces a case of déjà vu all over again.

For what should surely be at stake in the forthcoming election is not whether the country goes backwards a little or a lot, but how it can move forward and close the gap between its present performance and its potential. I last spoke to this conference in 1991, when the theme was "Getting New Zealand out of the survival frame of mind". There are some uncanny parallels between that time and now. In both cases the economy was beginning a recovery. I said in 1991 that:

> The last thing we need is a recovery led by domestic consumption or investment in sectors such as residential housing. That would be simply unsustainable. A move to longer-run growth must be based on a shift in resources to export and import-replacing industries, driven by further improvements in competitiveness and higher profits in them. If manufactured exports are increasing at double digit rates of growth in volume terms in a year or two's time, that would be one of the surest indications that policy is on track.

I made the point that many New Zealanders who have not lived and worked in successful countries overseas still do not appreciate the scale of the changes in policies and attitudes that are needed in this country if we wish to aspire to overseas living standards. I quoted the editor of *The Economist* as saying the process of changing attitudes may take two decades or three. I also said that the retail sector has a job to do to innovate, cut costs and make the consumer's dollar go further, and to contribute to the competitiveness and success of industries such as tourism.

I suggest that all those messages remain valid today. New Zealand did achieve a sound recovery from the early 1990s, achieving growth rates of 5 percent in 1993, 6 percent in 1994 and 4 percent in 1995. There is no reason why we could not do so again by correcting our policy mistakes of recent years and making up for lost time. That would be the best possible news for New Zealand households, and for the retail industry.

**WHANGAREI BUSINESS AND PROFESSIONAL COMMUNITY**

# WHY IS NEW ZEALAND NOT DOING BETTER?

**ROGER KERR**
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**NEW ZEALAND BUSINESS ROUNDTABLE**

**WHANGAREI**
**14 MAY 1999**

# WHY IS NEW ZEALAND NOT DOING BETTER?

The questions I want to address are ones that many New Zealanders have asked over the past couple of years. Why isn't the New Zealand economy doing better? Why hasn't there been a greater pay-off from the programme of economic reforms? Shouldn't there be more gain after so much pain?

Those are good questions, and more could be said about them than I can cover in this short talk. Before suggesting some answers to them, however, we need to ask a prior question: 'How well has New Zealand been doing in recent years?'. Several points need to be made.

First, we can say with confidence that it is doing much better than if the post-1984 changes had not been made. I know of no serious commentator who disputes that proposition. Previous economic policies were simply unsustainable. They were generating ever-higher levels of public debt and rampant inflation as well as feeble growth and rising unemployment. Deep underlying and longstanding problems were being hidden by a tangled web of subsidies, protection and regulations, and ultimately by blanket wage and price controls. Our credit rating was falling, and in the absence of changes we could have become, within a few years, the kind of economic mess we used to associate with regions like Latin America. Nor would slower adjustment with looser fiscal policies have produced better outcomes, as Japan's sorry experience of negligible economic growth this decade illustrates.

Secondly, if we look at indicators of economic performance such as productivity and economic growth, it is clear that New Zealand is doing better than it was. Contrary to some earlier findings, the latest research on productivity published by the Treasury points to substantial improvements from 1993, aided by the effects of the labour market reforms of the early 1990s. In respect of real growth in gross domestic product (GDP), finance minister Bill English has recently noted that, using reasonable assumptions for the next couple of years, the economy will have averaged around 3 percent growth in the decade since 1991 compared with half that rate in the previous decade. Measures of productivity and growth are sensitive to the assumptions used, but there is little doubt that there have been real improvements.

Some ask why New Zealand is not doing better than Europe, since Europe has higher government spending ratios and is often regarded as more highly regulated. The differences are not self-evident, however. Although New Zealand is less regulated than Germany or Italy according to the Heritage Foundation and *Wall Street Journal*'s 1999 Index of Economic Freedom, it is not ranked more highly than France or Britain, and Britain and Ireland have lower government spending ratios than New Zealand. In any case, New Zealand's rate of economic growth this decade is much higher in relation to Europe, the Organisation for Economic Cooperation and Development (OECD) average and Australia than in either of the two previous decades. Based on data in the OECD's December 1998 *Economic Outlook*, New Zealand's average annual compounded rate of growth will be 2.8 percent in the period 1991–99. This is 47 percent higher than the 1.9 percent rate projected for the European Union countries and 23 percent higher than the 2.3 percent projected for the OECD. However, it is only 79 percent of the 3.6 percent rate projected for Australia.

By contrast, in the decade 1981–91 New Zealand's average annual compounded growth rate of 1.7 percent was only 65 percent of the European Union average, 57 percent of the OECD average and 64 percent of the Australian average. Nor was New Zealand's relatively poor performance during this period an aberration. During the decade 1971–81, New Zealand's average annual growth rate was 1.8 percent, 67 percent of the rate in the European Union, 53 percent of the OECD average and 56 percent of the Australian rate.

Thirdly, other important indicators of economic performance, such as inflation and the level of public debt, have also improved markedly. Growth is inevitably suppressed during a period when inflation is being brought under control. And just as a household forgoes current consumption when it is paying off debt, so too does a nation mark time in respect of material living standards when public debt is being repaid. But these are major gains nonetheless: inflation is no longer undermining economic growth and we are no longer bequeathing a large legacy of public debt to our children.

Having said this, one has to say that many economic trends, particularly since the mid-1990s, have been disappointing. The big gains in terms of economic growth, falling unemployment, substantial fiscal surpluses and low inflation followed the 1991 budget and the Employment Contracts Act 1991. Recently New Zealand has been losing ground. Growth has decelerated to the point where the economy went into recession last year. After falling from around 11 percent to 6 percent, the unemployment rate rose sharply and is still over 7 percent. Our external debt ratio which was also dropping is now rising again due to a very large and worrying balance of payments deficit. Far from regaining a triple A rating as seemed likely at one stage, our credit rating has been downgraded. Despite a very large fall in the value of the New Zealand dollar, our international competitiveness ranking has fallen from eighth to twentieth position. The agricultural sector is in dreadful shape. Although drought is currently partly to blame, more important causes are high tax burdens, land and environmental regulation and producer board monopolies. Meanwhile other statistics, such as welfare dependency, educational underperformance and crime, rightly concern people. The economy is regaining some momentum this year, but it is an unbalanced recovery and the outlook is not exciting. Why isn't New Zealand doing better?

To find what I believe is the right answer to that question, we have to go back several years. A country's long-term economic performance depends on underlying structural factors which change only slowly. Current events will always have a bearing on growth – the Asian crisis and the recent drought have clearly had an impact, as did the Gulf War and the electricity shortage earlier this decade. Monetary and fiscal stimulation or contraction will alter the economy's short-term path. But the factors that affect long-term performance for good or ill usually take many years to show up. The strong performance of the US economy in the past seven years owes much to the deregulation and restructuring of American industry in the 1980s. Commentators on Australia's good performance today typically put it down to 15 years of reform efforts by federal and state governments. Their efforts have not always been as well-designed and as radical as some of New Zealand's reforms – many would say Australia did not need to take such drastic action – but the difference is that they have been sustained. Australia's ratio of government spending to GDP will have fallen for eight successive years to 33.3 percent in 2000, according to the OECD's December 1998 *Economic Outlook*. New Zealand's ratio is projected to be 40.4 percent in the same year, fractionally higher than in 1994.

When we look back, we see that New Zealand really had only two bursts of serious reform over the past 15 years – under a Labour government from 1984 to 1988 and under National in 1990/91. These were followed respectively by the Lange and Bolger teabreaks. Since the last teabreak has gone on for seven or eight years, during which time other countries like Australia have implemented most of our earlier reforms and done more, it is galling but not surprising that New Zealand is now lagging again.

The warning signs have been unmistakable for a long time. I recall that in 1992 I gave a speech which had the title *A Rattle of Teacups*? In it I quoted the advice of the most recent OECD report on New Zealand:

> To build on the reforms of recent years and to underpin the much-needed improvements in the country's medium-term growth prospects, it is essential for New Zealand to consolidate and extend the policy orientation pursued since the mid-1980s.

I pointed out that that was not happening. In its budget that year, the government had already shifted its stance. In 1991 it had clamped down on its spending even though the economy was in recession, and this action was a major factor in the export-led expansion that began that year. By the time of the 1992 budget, however, it was already easing up on the grounds that it did not want to kill off the recovery. The logical inconsistency was glaring. At the same time prime minister Jim Bolger was declaring privatisation of electricity and postal services off-limits. I pointed out in that 1992 speech that many other obstacles to a better growth performance, such as producer board reform, restrictive practices in the legal profession and the absurd rules governing pharmacy ownership, remained unaddressed. They are still in the too-hard basket today. In conclusion I noted that there was growing acceptance of the merits of the changes that had been made but said:

> The real argument is not about what has been done. The real argument today is about whether we are prepared to do more to achieve assured success or whether we are content with a still fairly mediocre and risky outlook, and want another teabreak.

After the 1993 election and the dumping of finance minister Ruth Richardson, it was perfectly clear what was in store. Early in 1994 the then chair of the New Zealand Business Roundtable, Douglas Myers, gave a speech entitled *Two Scenarios for New Zealand*. One of them he called the 'fast-forward' scenario, under which New Zealand pressed on with efforts to improve its economic structure as the OECD had recommended. The other was the 'rewind' scenario, under which he said New Zealand could snatch defeat from the jaws of victory by reverting to high spending and growth-destroying policies. He mentioned the recent introduction of a youth minimum wage as the start of a process which MP Max Bradford had described as "death by a thousand cuts". Regrettably, the 'rewind' scenario is the one that, by and large, New Zealand has followed.

I felt it was worth reminding you of these assessments because, if you were to believe many letters in newspaper columns, the New Zealand Business Roundtable has been running the country for the past 15 years. The reality is that through perhaps a third of that period we have supported efforts by governments to implement policies that we saw as broadly correct for New Zealand, and that we have become increasingly at odds with the direction and drift of policies for the past several years.

Coming closer to the present time, the country's problems were compounded with the change to the Mixed Member Proportional (MMP) electoral system and the coalition government that followed the 1996 election. These changes added further uncertainty to the country's directions and the business environment. The worst result of the coalition negotiations was the totally irresponsible commitment to a further $5 billion of generally low quality government spending, on top of an already strong upward trend. The extent of this irresponsibility still seems to be poorly understood by New Zealanders. The $5 billion sum over three years can be contrasted with the additional spending plans of the Australian government announced in this week's budget (May 1999) which total under NZ$4.5 billion over three years. Australia is an economy nearly seven times larger than New Zealand. More recently, the government's spending plans have been marginally cut back, but government spending has accounted for a larger share of the economy in each of the last three years. It is little wonder that the private sector has been struggling throughout this period.

Since the coalition broke up, there have been a few worthwhile initiatives such as the partial opening up of the accident insurance market and the sale of Contact Energy, but overall not much has changed. The business sector is still burdened by developments in recent years such as the reregulation of the labour market by the courts, inefficiency in local government, and the economic and compliance costs of the Resource Management Act 1991 and legislation on human rights, privacy and occupational health and safety. There is a strong momentum towards increasing regulation of land use, businesses and commerce.

According to the office of the minister of commerce, over 1,600 new pieces of legislation and 3,600 new regulations have been introduced in the past decade. The current drive to regulate for hazardous products, heritage sites, biodiversity, energy efficiency, biogenetic labelling and carbon emissions illustrates the pressures. We are busy making ourselves into another Tasmania. In contrast, there is no real momentum behind initiatives like privatisation, producer board deregulation and roading reform. In some areas we are seeing backward movements such as the proposals to bring in paid parental leave, reintroduce price controls on electricity and move away from light-handed regulation under the Commerce Act 1986. For all these reasons, I suggest the answer to the question: 'Why is New Zealand not doing better?' is fairly plain.

What is more, the answer I have given you is very much the same as the assessment by the OECD in its latest report on New Zealand which came out at the beginning of May. The OECD said that New Zealand had been on the right course since the mid-1980s but pointed out that achieving strong economic performance depends on the government getting many things right. It was critical of the inconsistent progress towards a more prudent fiscal position and of the quality of spending. It pointed out that "the attainment of long-term fiscal goals that had been within reach [had] now been pushed well into the next decade". It commented that businesses were hampered by cumbersome redundancy and dismissal procedures, advised the government to avoid a further increase in the minimum wage, and repeatedly criticised the slowness of producer board reform and bulk funding of schools. It urged the government to follow through on the "largely stalled programme of privatisation" and to introduce more competition in health, education and local government. Overall, the OECD noted that many policy commitments had been made but remained unfulfilled, and stressed the need for "an ongoing – rather than stop-and-go – reform effort".

Are there alternative explanations for New Zealand's mediocre performance that are worth considering? Frankly, they are hard to find: around the world the arguments for greater economic freedom as a means to growth have largely been won. At an Asia Pacific Economic Cooperation (APEC) meeting involving small and medium enterprises (SMEs) in Christchurch in April, I was struck by the consensus on the fundamentals that have been stressed in New Zealand over the past 15 years: sound monetary and fiscal policy, reducing barriers to trade and compliance costs, deregulation to create competitive markets, protection of property rights, reducing tax distortions, private sector involvement in infrastructure, and the promotion of an enterprise culture and business skills. One of the few critics of these priorities, the *New Zealand Herald*, in its business section, has dismissed them as "formulaic" and "increasingly irrelevant". But how many of them can be regarded as more than partially achieved in New Zealand today?

It is vital that there should be ongoing debate about how New Zealand can do better: nobody has ever accused the Business Roundtable of being afraid of debate. But proposals need to be based on a coherent understanding of how an economy works, and be backed by sound economic theory and evidence. It is not enough to make assertions unsupported by reputable research and authorities. It is not enough to look at a country and fasten on one element of policy without assessing whether it is helpful or harmful and how it relates to other, possibly far more important, reasons for that country's success or failure. Two years ago the *Herald* was telling us that nothing was wrong with New Zealand's policy framework and that business should stop criticising and get on with the job. Today it is saying New Zealand needs new directions – basically more "active government" – and should be going in for things like preferential tax rates and subsidies, regulation of company takeovers, heavier regulation of electricity and telecommunications services, and big increases in spending on education.

None of these approaches is recommended in the report of the OECD, which reflects mainstream economic thinking. Most have been tried and failed in the past. Tax concessions and subsidies to one industry are inevitably a cost to other industries. Capital and other economic resources are misallocated away from industries that can stand on their own feet to those that are only profitable with taxpayer assistance. An open market for corporate control is vital for business efficiency: the consensus at a recent conference of business law professionals convened by the Ministry of Commerce was that "the [takeover] code should be buried for good". Deregulation of the electricity and telecommunications markets has produced large benefits for consumers, and price controls have never worked. Finally, while education is obviously very important, there appears to be no strong, systematic relationship between school expenditure and student performance. The relationship between a country's educational spending and its economic performance also appears problematic. In any case, the billion dollars of extra spending on education in recent years has had no clear, positive results. The urgent need is to address the dysfunctional aspects of the system, especially the extent of the state monopoly of education.

Whether the message is boring or not, I believe the business community must keep focused on the basics. It took years to achieve better policies during the Muldoon era, but good arguments finally won out. We learned in that period that there is no magic bullet, no salvation in expedient quick-fixes. The business community said 'thanks but no thanks' to the $100 million of so-called business assistance offered by the coalition government, and argued for lower spending and taxes instead. I hope it maintains that position. Good long-term growth is about maintaining a sound and predictable economic environment, rejecting protection and privilege, and striving for smaller and more effective, not bigger, government.

As a final point, I believe modern economics teaches us that there is no difference between the economic policy interests of large and small businesses. The SME conference in Christchurch came up with essentially the same prescription for growth as that promoted by the OECD and by our organisation. After all, large businesses are usually just small businesses that have succeeded and grown because they have produced what consumers want to buy. In any case, few of New Zealand's businesses are large by international standards, some are collections of smaller businesses, and still others are divesting non-core activities in line with worldwide trends. Large firms may have more systems to cope with burdensome regulations than small ones, but small ones may just ignore them: either way, the community as a whole suffers through more costly goods and services or disregard of the rule of law. What the community needs is efficient businesses, whether large or small, and we should reject suggestions that the business sector has divided interests.

So, if we want New Zealand to do better, as I and most people I know in business most definitely do, then I suggest the way forward is pretty clear. It is to return to the path that New Zealand was following when we were making good progress, and to press ahead. It also means finding more effective approaches in many other areas such as education, health, welfare, superannuation and the Treaty of Waitangi. All of these areas feature on the work programme of the Business Roundtable because the business community recognises that good policies in these areas are vital for economic and social progress.

There is no reason why New Zealand cannot achieve much greater economic and social success. But doing better will require better policies, as well as continuing efforts by businesses of all sizes to improve their contribution to the economy. At present the quality of New Zealand's policies is no better than average, and therefore we should not expect better than average economic performance. We must improve the quality of policies if we want to rejoin the ranks of the world's most successful countries in the early part of the next century, and we should aspire to nothing less.

AUCKLAND REGIONAL CHAMBER OF COMMERCE
AND INDUSTRY

# WHO CARES?

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

AUCKLAND
6 MAY 1999

# WHO CARES?

Shortly after the overthrow of the communist regimes in 1989, Rolf Dahrendorf, the former head of the London School of Economics, made a very perceptive remark. He said:

> It will take six months to reform the political systems, six years to change the economic systems, and sixty years to effect a revolution in the people's hearts and minds.

Ten years down the track, the truth in this remark is evident in the confused politics of many ex-communist countries. Fifteen years after New Zealand's Berlin Wall began to be dismantled in 1984, the struggles of people coming to terms with change are still evident on talkback radio any night.

In an article in the *New Zealand Herald* last year, John Roughan summed up the state of mind of a significant part of the electorate. He described it as follows:

> It is a world that does not recognise signposts of left and right let alone the inevitable choices confronting those who must make decisions. It does not like what has been done to the country but does not want to go back, wants unlimited public spending and low taxes, likes universal benefits but not dole bludgers, distrusts both public servants and privatisation, detests politicians but talks passionately about little else.

This state of mind is not very helpful in making clear choices if New Zealand wants to go forward. It should worry all of us as the country approaches another general election.

I spoke to this chamber shortly after the last election and before the coalition government was formed. On that occasion I suggested that New Zealand was entering "dangerous waters". I said:

> The economic outlook for the next three years is already far less exciting than it should be, and [the government's forecasts] may turn out to be optimistic. The economy has lost competitiveness and many export industries are under stress. It would not be surprising if the rate of growth falters and unemployment starts to rise again in the near future. Lower tax receipts and higher welfare payments would quickly turn around the government account from high and rising surpluses into budget deficits. Our return to 'borrow and hope' territory will be even speedier if politicians indulge in fiscal irresponsibility in their eagerness to be part of a coalition government.

I get no satisfaction from observing that that scenario has, by and large, materialised. National went into the last election with a commitment to achieve annual economic growth of 3.5–5 percent. It was a plausible commitment. The economy had been growing at that rate over the previous four years after a sound and balanced framework had at last been put in place in the early 1990s. Last year the United States and Australia both grew by around 5 percent despite the Asian crisis. By contrast, National will achieve less than half the growth it targeted over this parliamentary term. Today I gather that it is not possible to fail in our education system, but when I went to school less than 50 percent was a failing grade.

The sources of the present predicament go back several years. Prime minister Jim Bolger called a halt to major policy improvements after 1993: he described our ideas for building on the country's previous achievements as "too ambitious". He was also the midwife to the Mixed Member Proportional (MMP) electoral system. His government initiated the huge increase in government spending which has accelerated under the coalition and is still ongoing. New Zealand has fallen from eighth position in the world competitiveness rankings in 1995 to twentieth position in 1999 – below where we were in 1991 and nearly at the bottom of the Organisation of Economic Cooperation and Development (OECD) group of countries.

Local and overseas investors finally blew the whistle on New Zealand and marked down our credit rating and the currency, and the economy now appears to be on a modest recovery path. But the patient is far from healthy. The export outlook remains weak and the current account and external debt positions are at worrying levels. At best they will take another parliamentary term to correct. It will also take that time to get rid of MMP. I believe the electorate will throw it out if it is given the opportunity, and in the interests of better government it should demand the right to have another say.

So at the earliest New Zealand may lay the foundations for sustainable growth again nearly 10 years after it lost its way. We will have suffered a whole decade of drift and lost opportunities.

Some ministers in the National cabinet think that assessment is too harsh. In their view the business community has not given them enough credit. Things could have been worse, they say. They did cut government spending back a bit last year. They have made important decisions on tariffs and accident rehabilitation and compensation insurance (ACC). The prime minister stated in February that the government will be "very busy indeed" this year implementing decisions on the Resource Management Act 1991, producer boards, local government, roading and the tertiary education review.

But will these very necessary things happen or will the government still be talking about them when it goes into the election? Will the May budget see government spending and debt ratios tracking towards the government's objectives or still going in the wrong direction? Will producer board reform still be in the too-hard basket, biasing New Zealand's agricultural production towards low-value commodities? Will the government even start talking about unemployment and the need to repair the damage the Employment Court has done to the Employment Contracts Act 1991, or will it continue to make job creation more difficult with new age discrimination legislation and perhaps paid parental leave?

I am sure we can all sympathise with the problems of ministers trying to make the most of the cards they have been dealt by MMP and minority government. But at the same time we must keep pointing out the widening gap between New Zealand's potential and its performance. We must remind them of Winston Churchill's message: "It is no use saying 'we are doing our best'. You have got to succeed in doing what is necessary". All of us in business have to accept that discipline every day, and we should expect no less of our political leaders. A clear vision and sound policies are the best recipes for both business and political success.

In their more candid moments, members of the present government acknowledge they have not made a good fist of things but tell the business community that the centre-left parties would be worse. This too may well be true, but it is both a weak excuse and a sad commentary on the Labour Party, which did so much in the 1980s to rescue New Zealand from the prospect of terminal economic decline.

There can be absolutely no doubt that current Labour policies would do further damage to an already battered economy. The list of policies that would be harmful for growth includes a review of the Reserve Bank of New Zealand Act 1989, a review of the tariffs decision, higher levels of government spending, an increase in the top personal tax rate, an end to privatisation, interventionist industry policies, major changes to the Employment Contracts Act 1991, a reversal of the ACC and housing reforms, an increase in pension levels, the abandonment of salary bulk funding of schools and a return to a more centralised health system with elected area health boards. It is a list of policies that have been tried and failed. Even Savage, Nash and Nordmeyer, who were fiscal conservatives, would be horrified at Labour's 'big government' stance today.

The contrast between 'Old Labour' in New Zealand and 'New Labour' in Britain continues to grow. Our Labour Party wants to put up taxes whereas the Blair government is reducing business and personal tax rates. Labour here is against privatisation while Blair's party is for it. New Zealand Labour has shifted back to universal social benefits whereas the Blair government is pursuing means testing. Tony Blair has embraced the Thatcher legacy whereas Labour seems to want to forget the 1980s reforms ever happened. Steve Maharey, the Labour MP for Palmerston North, has stated categorically that Labour would end 'more market' policies – it still hankers after regulation and controls. Labour offers no vision for the future. It all reminds me of the fate of one of the writer Robert Frost's characters, "the fate of having nothing to look backward to with pride and nothing to look forward to with hope".

It is not as though the Labour Party has not been looking for ideas, but it has been looking in the wrong directions. Last year it brought to New Zealand Robert Reich, a former secretary of labor in the Clinton administration. Reich is a 'yesterday's man' in American policy debates. Nevertheless, even he accepts the reality and desirability of globalisation; he rejects state ownership of the economy; he says that wages should be flexible and employers should have wide latitude in hiring and firing employees; he believes that social safety nets should be trimmed and able-bodied people put to work; he advocates education vouchers (effectively an extension of bulk funding); and he points out that high subsidies to tertiary education are a transfer from poor to rich. Why isn't Labour listening to these messages instead of pandering to public sector unions and other special interests? Instead it seems to prefer all the outdated features of Reich's thinking, especially his residual attachment to big government. As David Boaz of the Cato Institute, Washington DC, has put it:

> Social democrats like Reich concerned about community values ought to reflect on what their policies have done to divide Americans. They've given government so many tasks, and so undermined the old notions of personal responsibility and morality, that government can no longer perform its basic function of protecting us from physical harm. They have centralised and bureaucratised the schools so that little learning goes on there. They have nationalised and bureaucratised charity. Is it any wonder that people flee the institutions thus created?

The Labor Party in Australia went into the election in October 1998 on a backward-looking platform and lost. It is now having to fundamentally review its stance. The Howard government campaigned on a pro-reform platform and won. It is now pressing on with renewed confidence, as Australia enjoys the benefits of 15 years of sustained reform. One would like to think the lessons will not be lost on New Zealand political parties.

Some might find it hard to understand why political parties in New Zealand favour backward-looking policies given the evident trends around the world towards policies of economic liberalisation, privatisation, lower taxes and generally smaller government. But we should realise that political parties adopt policies that they believe a significant share of the voters will support. Ultimately it is community understanding of what makes for national success that matters, and we should not direct all the blame to politicians. New Zealand is a more economically literate country today, but still not literate enough. People in politics, business, academia and the media have still not done enough to get across to the community how its aspirations can best be met.

People are quite rightly concerned about living standards, jobs, security in old age, and the fortunes of those less well off than themselves. In the past they have associated big government with compassion and economic security. Those of us who do not believe big government is the answer must work harder to show people that we have better answers.

We must remind them that protectionist policies aimed at insulating New Zealand from the rest of the world sapped both our prosperity and our security. We must stress David Boaz's point that welfarist policies ultimately destroy social cohesion, and recall that when the Bible talks about being our brother's keeper it is not talking about giving the job to Big Brother. Politicians must find new ways to connect with the average voter. They must explain that better policies are not about following some ideology but about making people better off. They must give the community the confidence to vote for changes that are necessary for progress rather than opt for the timid politics of muddle-through.

Prior to the last election, the New Zealand Business Roundtable and the Auckland Regional Chamber of Commerce and Industry set out their answers for taking New Zealand forward in the report *Moving into the Fast Lane*. The answers are as valid today as they were then. The essence of them is the need for smaller government – we suggested as a medium-term goal that government spending and tax burdens should be no more than 20 percent of the economy, mainly by keeping the rate of growth of spending below the rate of economic growth. In making our case we have the great advantage of being able to demonstrate that when such policies were heading us in that direction a few years ago, New Zealand was making outstanding progress. For example, the Maori unemployment rate which stood at 25 percent in 1992 was down to 15 percent by 1996. It should have been below 10 percent by now but instead is back up to 20 percent because the government dropped the ball. As Treasurer, Winston Peters did not set out to achieve this result – indeed he had ambitious ideas about growth which I was one of the few to publicly support – but he simply did not understand how the economy works. Far from moving into the fast lane, the economy ground to a halt last year.

We do not need to look beyond New Zealand for the lessons of both success and failure, but if we do we find exactly the same lessons. For example, it has become fashionable to look to Ireland as another economic success story. The *New Zealand Herald*, in its business pages, somehow contrives to represent Ireland as a story of active government intervention. It has failed to cite any authority to support this bizarre interpretation. Yes, Ireland still subsidises some of its industries, particularly agriculture, but where is the evidence that this has helped rather than harmed its economy? Leaving aside the generous help from Brussels, the reality is that Ireland's success has been built on essentially the same foundations as New Zealand's earlier success. Ireland has opened up its economy and pursued less interventionist policies to the point where it now ranks seventh equal in the world in the latest Heritage Foundation/*Wall Street Journal* Index of Economic Freedom. Its ratio of general government spending to gross domestic product (GDP), perhaps the best indicator of the level of government intervention in an economy, has fallen from over 50 percent in the 1980s to a projected 32 percent next year (well below New Zealand's 40 percent ratio). Tax rates are correspondingly low – just 10 percent on some forms of investment. Let us by all means follow the Irish model, including by making further efforts to get tax rates on investment down, but remember we discovered it first.

Both New Zealand and Ireland have shown that small economies starting with an agricultural base can modernise and prosper, given a determined commitment to the right policies. As someone once said, what matters is not the size of the dog in the fight but the size of the fight in the dog. But small economies have to stand out by the excellence of their policies in today's world, or their attractiveness quickly fades. That has been New Zealand's recent fate: we have disappeared again from the investment world's radar screens. Even more disturbingly, the inflow of people in the early 1990s has turned into an outflow of many young, skilled and entrepreneurial people. According to a recent report, almost 33,000 New Zealanders will move to Australia this year. An increase in the top personal tax rate would only exacerbate this exodus, and force New Zealand firms to increase salaries at the higher levels to try to combat it. How this helps anyone, and those on low incomes in particular, defies comprehension.

New Zealand can recover from its recent setbacks. There is no reason why we cannot achieve the vision set out in *Moving into the Fast Lane* of becoming a high growth, high employment country, doubling average incomes in 10 or 15 years. We were doing better than Australia in the early 1990s and could do so again. I for one will not be happy until I see a Maori unemployment rate well below 5 percent, older people feeling safe in their homes, welfare rolls back to where they were in the early 1970s, and young New Zealanders eager to return to careers at home after having a taste of the big wide world abroad.

However, a serious doubt that I have about New Zealand at present is whether enough people understand the realities of modern economic success. Rolf Dahrendorf's warning about people's propensity to cling to failed ideas is a sobering warning. The electorate still has an appetite for snakeoil. The *Business Herald*'s push for subsidies and takeover regulation is misguided, yet it resonates in some quarters. The media have given enormous coverage to businessman Dick Hubbard who promotes Levi Strauss as a model of a socially responsible and profitable business – a company whose share price has fallen 40 percent in the past three years and which has had to lay off 16,000 workers. Its policies were socially irresponsible and it has now abandoned them. MMP was another delusion, as proportional representation has proved elsewhere. The vast majority of Italians who were concerned enough about Italy's future voted against proportional representation in the recent referendum, although the turnout was just below the 50 percent threshold needed to effect change. If the public and the media keep falling for such delusions, the chances of putting in place sound policies and sticking with them are not bright.

Equally, I wonder who really cares about our present state of drift and wants the country to do better. It seems to me that there has been a serious loss of national ambition, and even a lack of apparent public concern about New Zealand's underperformance. I am reminded of the Muldoon era when national decline was almost taken for granted. Where is the leadership and the passion? When did you last hear the treasurer reaffirming National's commitment to a 3.5–5 percent growth rate? When did you hear the minister of labour giving a serious address about our totally unnecessary rate of unemployment? Mobilising support for doing better is hard work, but acceptance of stalemate and mediocrity will only make things worse.

Within the business sector, the ranks of business leaders who have made major contributions to public affairs over the past 15 years are thinning out. The vacuum has been filled by people like Dick Hubbard whose mission is not to promote the interests of business – he does not even belong to this chamber – but to promote muesli. Nothing wrong with that, but no one should confuse the two missions. Those who understand how business and the economy work within society as a whole must re-engage in the debate, must support your business organisations, and must back sound policies proposed by any political parties. If, for example, the National Party commits itself to achieving an income tax structure with rates of 15 and 25 percent, as has been mooted, it deserves the whole-hearted backing of business.

There can now be no excuse for mistaking what constitutes a sound and successful strategy for a country. The directions in which New Zealand has moved over the past 15 years have been followed by every single OECD country and many others as well. Politicians like François Mitterand in France and Oskar Lafontaine in Germany who tried to swim against the tide found political support for their policies disappeared. But no strategy will succeed if it proceeds only in fits and starts. As the Australian prime minister, John Howard, put it recently:

> There is no alternative in the modern, globalised economy in which we all live than to go on indefinitely with the process of economic reform.

We all know our businesses need to be re-invented constantly, and so do many of a nation's policies and institutions. Yes, it is hard for a country to escape its history, but it is not impossible. Within the past generation, countries such as Britain, Ireland, Australia, Chile, Argentina and many in Asia have been genuinely transformed for the better. There is absolutely no reason why New Zealand cannot continue its progress and catch up with the leaders. Economic progress requires sustained effort, year in and year out. A renewed commitment to reform would not only restore our confidence but could equally, as in Britain, eventually secure the acquiescence of the centre-left parties in the new policy regime.

John Howard made one more point. He said that with the Australian economy doing so well, it was precisely the time to press ahead with changes that would increase the prosperity and security of Australians. This was the message Jim Bolger chose to ignore in 1993, and we have paid a heavy price for his extended teabreak. With the economy gathering at least some momentum again, the next government must not let the opportunity pass. Those who care about the country's future must insist that the government gets the economy back on track. They must insist that parliament gives the country the opportunity to throw out MMP to overcome the present paralysis. All of us know we cannot be second rate in business today, and there is no reason why New Zealand should be second rate as a country. Being first rate is the only standard we should be willing to accept.

# FISCAL POLICY AND THE PUBLIC SECTOR

FRANCHISE ASSOCIATION OF NEW ZEALAND

# THE PITFALLS OF BACKYARD TAX POLICY

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ROTORUA
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# THE PITFALLS OF BACKYARD TAX POLICY

Personal tax rates are likely to be a significant election issue. The National party proposes to introduce a three-step tax scale that would increase the level of income at which the top rate is applied and generally lower the rate of tax paid on middle incomes. In contrast, the Labour party proposes to introduce a new top rate of tax of 39 percent on incomes above $60,000.

The broad objective of tax and other policies should be to increase the overall welfare of the community to the maximum extent possible. Community welfare can take the form of higher output and incomes – and hence better material standards of living – increased opportunities for leisure, and/or other non-material benefits. Policies that are good for one person are usually beneficial from a community perspective, but there are some circumstances where the interests of an individual and those of the community as a whole conflict. In such cases it is the latter interests that are of prime importance. While questions of fairness and equity also arise, issues related to income distribution should, in my view, largely be addressed through welfare policies.

How do the tax proposals of National and Labour measure up against this standard?

The level of the tax burden is a key factor in judging the effect of tax policies on community welfare. Government spending is the best measure of the tax burden. Spending must generally be funded from current tax revenue or borrowing. As borrowing must eventually be repaid from taxes, it is effectively deferred tax.

The government has a vital role to play in advancing community welfare, but it is a limited one. In 1651 Thomas Hobbes described life without government as "nasty, brutish and short". To avoid that outcome the government should be responsible for maintaining personal and national security, protecting property rights and setting the 'rules of the game' for wealth-creating endeavours. It should also facilitate the supply of goods and services that cannot be produced by the private sector and provide a safety net for people in need who cannot be helped in other ways, for instance by families and charities.

Some people may think that government spending should be increased until the point where the last dollar spent produces a dollar of benefits. However, this would lead to too much spending. The economic cost of raising the last dollar of revenue is greater than a dollar because taxes distort the behaviour of individuals and firms. This cost includes lower output, incomes and employment, and distortions to a host of other choices that people make every day. Some New Zealanders may decide to live in another country if they are taxed too heavily.

There is considerable research which concludes that the total economic costs of raising revenue are very large, probably close to 30 cents for the marginal dollar of taxation in New Zealand. For this reason we should use tax revenue sparingly and 'economise' on the amount of activity that we expect of the state. Such research has encouraged many countries, including New Zealand, to reduce their rates of income tax over the past couple of decades. Tax reductions have focused on lowering high rates of tax in particular.

New Zealand's tax burden is not declining. Government spending under National will increase by about $6 billion during the nine years to the end of the present parliament. Central government operational spending currently amounts to about 35 percent of gross domestic product (GDP). This ratio has not declined since 1994/95 despite the government's long-run objective under the Fiscal Responsibility Act 1994 of reducing it to 30 percent of GDP. The ratio is forecast in the recent budget to decline only slightly by 2001/02.

National's proposed tax reductions will cost $400 million a year. They were termed a 'down payment' on further reductions by National. However, such commitments are not credible unless the government spending ratio is also projected to fall. John Major's party in Britain similarly lacked credibility in claiming to be "instinctively the party of lower taxes" when it was in fact increasing spending and taxation. A serious programme of tax reductions requires a much more disciplined approach to spending than has been the case since Ruth Richardson lost the finance portfolio in 1993. Moreover, National has said that for every dollar of tax reductions, spending will be increased by a dollar. Thus it is promising to increase spending when a reduction in the tax burden is required to support credible tax cuts.

Labour, on the other hand, is clear about its intention to increase spending significantly. The credibility issue for Labour is that its new spending is far in excess of the additional revenue, reported to be up to $340 million, that might be raised by introducing a new top tax rate of 39 percent. It proposes, among other things, to partly restore the 1991 benefit cuts, to boost education and health spending, to fund industry development, to extend Accident Rehabilitation and Compensation Insurance (ACC) to sickness and to pre-fund New Zealand superannuation.

New Zealand governments have engaged in many activities that extend beyond their proper role. It is implausible that the current level of government spending generates benefits commensurate with its costs. A sizeable reduction in spending and taxes would be good for the economy and for the community.

Tax reductions should be designed to generate the largest possible gain in community welfare. High rates of tax impose disproportionately large costs. Moreover, it is the level of tax payable on the next dollar of income (marginal income) that affects key decisions such as whether to work, engage in training or take a promotion. For these reasons, public policy should focus on reducing high rates of tax that apply to marginal income. The top rate of personal tax is the main case in point.

The top income tax rates particularly affect the tax burdens on capital income, which are especially costly to the community. Investment that would be profitable from a community perspective is discouraged, thereby harming growth and job creation. A tax on capital income increases the pre-tax rate of return required to attract foreign investors to New Zealand. The rate of company tax is a key rate that applies to income from inward direct foreign investment. A reduction in it would encourage investment and economic growth.

The broad direction of policy should be to lower and flatten the income tax scale. Income earned through companies, superannuation schemes, life insurance funds and trusts is more likely to be taxed at the appropriate rate under a flatter tax scale. The greater the extent to which effective marginal rates of tax move away from a flat rate, the more difficult it is to tax such income at the appropriate rate.

The present tax structure was predicated on the adoption of a relatively flat tax scale. The tax rates that applied before July 1996 were broadly consistent with that assumption. The majority of taxpayers were subject to the middle marginal tax rate of 28 percent or the top rate of 33 percent. Some people receiving welfare assistance or with student loans faced higher rates of tax. The top rate was reflected in the rates of tax applicable to company income, fringe benefits and superannuation schemes. People on the top rate were taxed appropriately while the penalty imposed on taxpayers who obtained fringe benefits or saved through superannuation schemes and were taxed on the middle marginal rate was relatively small.

The tax changes introduced in 1996 and 1998 resulted in a more uneven tax structure. They widened the gap between the top tax rate and the middle effective marginal income tax rate from 5 percentage points (33 percent and 28 percent respectively) to 12 percentage points (33 percent and 21 percent). In addition, the income level at which the top rate first applies was raised from $30,875 to $38,000. The incentive to split income among family members was greatly increased. The changes were made to distribute some of the benefits of the country's economic reforms to low- and middle-income earners. This was a reasonable goal, but the fact that higher tax rates were not cut at the same time led to much more serious distortions in the tax scale. People on lower and middle incomes saving through superannuation schemes and life insurance funds now face excessive levels of tax. As the TOLIS (Taxation of Life Insurance and Superannuation) exercise demonstrated, it is impossible to find a satisfactory solution to this problem short of lowering the top tax rate.

The introduction of the three-step tax scale proposed by National would make the tax scale even less uniform and would greatly accentuate the problem caused by the 1996 and 1998 changes. At present the first $9,500 of 'labour' income is taxed at an effective rate of 15 percent. This takes account of the statutory rate (19.5 percent) and the low-income rebate (LIR). The rebate applies to labour income, such as wages and salaries, New Zealand superannuation and benefits, but not investment income. The LIR is phased out as income increases beyond $9,500 such that the average rate of tax on an income of $38,000 is 19.5 percent.

National proposes to abolish the LIR and introduce a new statutory rate of tax of 15 percent on income up to $9,500. The effective rate of tax on labour income up to $9,500 would remain unchanged. However, the tax rate on any investment income included in the first $9,500 of income would drop from 19.5 percent to 15 percent. The next element of National's proposal is to replace the middle effective rate of 21 percent with a statutory rate of 20 percent. The third element is to lift the threshold at which the top rate of tax applies from over $38,000 to over $40,000.

National's proposals are a backyard approach to tax policy. In terms of the objective of promoting economic growth, the government would gain little 'bang from the taxpayer's buck' because much of the $400 million will be spent in reducing tax on intramarginal income, that is, tax that does not affect people's decisions to work, save or invest. The focus is on income redistribution, not wealth creation. The half a million taxpayers who earn more than $38,000, for instance, would gain a windfall of $285 a year from the introduction of the new bottom rate. The extension of the top threshold would provide a further windfall of $260 a year for people who earn more than $40,000. However, the tax rate applied to any extra income will continue to be the top rate.

The relationship between personal rates of tax and related rates of tax that apply to fringe benefits, superannuation contributions paid by employers and income earned by superannuation schemes and life insurance funds would come under additional pressure. The proper effective marginal rate of tax for many taxpayers who earn these forms of income would be 20 percent, or some 13 percentage points below the top rate compared with 5 percentage points up to 1996. For a few taxpayers the appropriate rate would be 15 percent. Instead they would be taxed at a rate 18 points higher. These are very wide gaps.

One consequence of these moves would be that the argument that fringe benefits, superannuation contributions, superannuation schemes and life funds should be taxed at a lower rate than the top rate would be strengthened. If that were to happen top rate taxpayers would exploit the opportunity and we would be back to the so-called tax effective remuneration packages that were common only a few years ago.

There would also be pressure to introduce a new resident withholding tax rate of 15 percent for people such as school children who earn small amounts of interest or dividend income. On the other hand, the present 19.5 percent withholding rate would need to be lifted to 20 percent. This has led Grey Power to observe correctly that a superannuitant with $5,000 of investment income would pay more in withholding tax than at present.

The proposed scale would increase the scope for tax avoidance. The present rate of 19.5 percent on modest amounts of investment income does not create a strong incentive for high-income earners to shuffle their investment income among family members. A bottom tax rate of 15 percent would encourage this simple form of tax avoidance. The lifting of the income level at which the top rate applies would also foster income splitting. Before July 1996 the maximum annual saving per recipient from transferring income from a top rate taxpayer to a non-earner (say, a child) was about $2,780. Under the proposed scale it would be $5,675.

Another consequence is that the chances of flattening the tax scale would be reduced. We would hear political arguments that subsequent moves to cut the top tax rate would disproportionately benefit higher income taxpayers.

The earlier tax scale was generally well designed. The LIR provision reflects a compromise between the merits of taxing intramarginal income of middle and high income earners at a level that reduces the need for excessive rates of tax on marginal income, and a desire to impose a lighter tax burden on people with a low income. Concessionary rates of tax are not justified for all people on low incomes. Tertiary students, for example, are assisted in other ways while school children, young adults and spouses who work part time are often from high-income families.

In Australia the first A$5,400 of income is generally free from tax. While this reduces the tax burden on people who depend on low incomes, it confers the same benefit on millionaires and requires a higher tax rate on marginal income. It is a very costly way of helping people on low incomes. New Zealand began extricating itself from a similar trap in the 1970s. The abolition of the LIR and the lowering of the bottom statutory rate would be a mistaken step backwards.

National has advanced two main arguments for its tax scale. The first relates to simplicity and the second is that people do not know their effective marginal tax rates but would do so under the new scale. Both are questionable propositions. Simplicity is not an overriding goal. There could be nothing simpler than a world free from tax but that would not enable the government to undertake those functions that are necessary to avoid the anarchy that Hobbes described.

Most people who want to know how much tax they pay in total or on the last dollar earned can find out without too much trouble. In a recent *Assignment* programme unemployed people were able to state how much their take-home pay would increase if they took up jobs that were offered. They had to take account of income taxes, the phase-out of the unemployment benefit and the accommodation allowance. This is a more complicated calculation than those that are at issue here.

I would be greatly surprised if National's proposed tax scale was examined rigorously before it was announced or recommended by the Treasury or the Inland Revenue Department. The irony is that it is subject to similar criticisms to those that the Treasurer, Bill English, correctly made earlier this year of Labour's proposal.

Labour's proposal would also widen rather than flatten the tax scale. By increasing some of the highest tax rates it would increase the economic or deadweight costs of taxation and the other distortions of the tax scale inherent in National's proposals. Being motivated by a desire to increase government spending, Labour would increase New Zealand's overall tax burden.

Labour has conceded that its new top tax rate would need to apply to fringe benefits. Logically it should also be applied to superannuation contributions, company income, and the income of superannuation schemes and life insurance funds. But Labour knows that such moves would be economically harmful and politically unpopular and it has sought to fudge its position.

While Labour likes to remind us that Australia has a top personal tax rate of 47 percent, it ignores several other features of Australia's tax system. The tax burden in Australia is less than in New Zealand – according to the Organisation for Economic Cooperation and Development (OECD), total spending by governments at all levels in Australia is around 33 percent of GDP compared with 41.5 percent in New Zealand. Australia is likely to reduce its personal and/or company rates in the next few years. New Zealand's income tax base is broader than Australia's. New Zealanders also face a 12.5 percent GST on their disposable income, higher than the less comprehensive goods and service tax (GST) of 10 percent which is to be introduced in Australia. Under Labour's proposals, the combination of a 39 percent tax rate and a 12.5 percent GST would mean that higher income taxpayers would be handing over nearly 50 percent of their income to the government.

There is also considerable scope to avoid Australia's high rates of personal tax. Superannuation savings, for example, are generally taxed at a low rate of 15 percent up to a high level of income – close to NZ$90,000. The Australian system facilitates many tax rorts, as every Australian knows.

If New Zealand were really serious about retaining or attracting the skills of outstanding innovators, entrepreneurs, artists and sports people, it ought to be setting a goal of applying a flat income tax of no more than, say, 20 percent. By going in the opposite direction, Labour will be sending a strong signal to productive people with international skills to migrate to countries with higher average incomes and/or lower overall tax burdens. To avoid losing people, firms will have to increase the gross salaries of many managerial and professional staff. This will add to the cost of doing business in New Zealand. The country loses all round.

There is actually a good case for looking at the idea of making New Zealand more attractive to high-skilled and entrepreneurial people by capping the maximum level of tax that any person would be required to pay at, say, half a million dollars a year. This approach would have several advantages. First, as the rate of income tax on income above the threshold would be zero, the behaviour of affected taxpayers at the margin would not be distorted by income tax. For such taxpayers the income tax would be close to the textbook example of an ideal lump sum tax. Secondly, many people on very high incomes would choose to pay the maximum tax rather than engage lawyers and accountants to manage their tax affairs and devise avoidance schemes. There would thus be a large reduction in activities which waste resources from a community perspective. Thirdly, government revenue would probably increase. I suspect that only a handful of individual taxpayers pay half a million dollars or more in tax each year. At present we are losing such people from the New Zealand tax base.

A taxpayer subject to such a cap would pay fully for their share of public spending and, in addition, make a large contribution toward government spending such as welfare support that benefits other people. Moreover, such taxpayers make a valuable contribution to society through the skills they offer. The government is trying to attract people with similar skills in other ways such as through favourable immigration rules. It seems foolish to have a tax regime that sends the opposite signals.

It is often argued that a reduction in the top tax rate is inequitable, but this case is easily overstated. First, while compassion for those in hardship justifies a tax-funded safety net, it does not justify the imposition of progressive rates of tax. The decisions to provide support and to fund it are separate matters. When all is said and done, envy turns out to be the only real motivation for a progressive tax scale. Secondly, annual income is often a poor measure of a person's welfare. If some people choose to work part time to have more time for leisure activities, are they less well off than others who work full time and are otherwise in the same position? Thirdly, progressive taxes tend to transfer income among different stages of a taxpayer's life rather than among taxpayers – hardly a result with a strong equity justification. People on high incomes will always gain the most from any tax cut because they pay a disproportionate share of tax. It is taxpayers' money that is being returned, not money that belongs to people who do not pay taxes.

It is interesting to note that in 1996 the *Reader's Digest* asked a sample of Americans to think about their total federal, state and local taxes, including income, sales, payroll and property taxes. It then asked "What is the highest percentage of income you think would be fair for a family making US$200,000 a year – almost NZ$375,000 – to pay when you add all taxes together?". The median answer was 25 percent – well below the 39 percent that such a family pays in the United States. Even more surprisingly, the result was consistent for males, females, whites and non-whites, and high- and low-income earners.

While the 1984–1990 Labour government tax reforms were designed to improve community welfare, the personal tax proposals that are to be put to voters in the coming election seem to reflect short-term political opportunism. They are motivated by the desire to appeal to targeted groups of voters rather than by an informed analysis of what is good for the country. Neither National nor Labour is demonstrating leadership. Their tax proposals illustrate the erosion in the quality of public policy that has occurred over the past few years. It is contributing to lacklustre economic performance, and it is little wonder that more people think the country is on the wrong track than those who think it is heading in the right direction. The community deserves better.

**NEW ZEALAND BUSINESS ROUNDTABLE**

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# SUBMISSION ON THE CHRISTCHURCH CITY COUNCIL'S 1999 DRAFT ANNUAL PLAN

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**JUNE 1999**

## 1 Overview

1.1 This submission on the Christchurch City Council's 1999 draft annual plan is presented by the New Zealand Business Roundtable (NZBR). The NZBR is an organisation of chief executives of major New Zealand businesses. Most of them operate in Christchurch, and collectively they account for around 10 percent of the Christchurch economy. 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 made submissions on the last six draft annual plans of the Christchurch City Council. We have been critical of the overall performance of the Council. Because little notice has been taken of our past submissions, we are not making detailed comments on this year's plan. Since the Council has made few relevant changes to its activities, we consider most of the comments we have made in the past remain valid.

1.3 The main theme of our previous submissions has been that the Council should concentrate on its core activities and divest itself of other functions. The core business of local authorities should be the funding and – in justifiable circumstances – the provision of local public good outputs that cannot be better provided by firms, households and non-profit organisations. Local authorities should also administer appropriate local regulation.

1.4 This role is derived from a principled analysis of how territorial councils can best promote the overall well-being of their citizens. It is not founded on ideology, as some members of the Council have claimed, but reflects mainstream policy analysis and advice. For example, governments of all political persuasions are privatising commercial activities that should properly be undertaken in the private sector. The submissions of other business organisations to the Council have been similar to our own.

1.5 The adverse consequences for ratepayers of the Council's lack of focus are becoming increasingly apparent. A significant proportion of the Christchurch population is in the low-income bracket. The Council's spending continues to expand, thereby forcing ratepayers to forgo personal consumption and savings to fund activities that provide dubious economic and/or social benefits. In many cases the value of services to subsidised consumers is likely to be significantly less than their cost. The community is poorer as a result.

1.6 The Council has sought to refute the NZBR's criticism of its ownership of commercial organisations by arguing that they are strategic assets and they reduce the level of rates. Recent legislation that required the Council to divest its interest in retail electricity distribution has undermined the former argument. Revenue from these sources and capital repatriation from Local Authority Trading Enterprises (LATEs) has encouraged the Council to increase its expenditure in preference to reducing its rates and/or long-term debt.

1.7 Our arguments for confining Council activities to its core business and for more efficient funding policies have been countered with the response that that is not what the public wants and that the Council is merely reacting to public pressure. However, there are many reasons why the overall interests of the community cannot simply be determined by collecting expressions of view through meetings, statistical surveys, polls and submissions. The Council is, for example, poorly placed to make informed judgments about people's preferences because it has 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 voluntarily decide to exchange one thing for another (for example an amount of money for, say, a service) that their actions are meaningful. The Council should be engaging in reasoned decision making based on sound professional analysis and advice, and giving a lead to the community on policies that are in its best interests.

1.8 The Council is adopting conflicting and self-defeating strategies to offset the detrimental effect of its actions on the welfare of its poorer citizens and on the rate of job creation in the private sector. On the one hand, the Council is inflicting substantial and unjustified cost on the commercial sector to avoid user charges and/or mitigate the level of rates that would otherwise be levied on low-value properties. Such costs lead to less business activity and investment and fewer jobs. On the other hand, the Council is directly subsidising employment and economic activity in a futile attempt to counteract the damaging effect on private sector investment and job creation of its rating and regulatory policies.

1.9 If the Council uses resources in activities that yield a lower return to the community than they would in the private sector, overall incomes and employment will be reduced. Moreover, the imposition of rates reduces employment in the private sector because people and firms are required to reduce their spending.

1.10 Incorrect and inconsistent interpretation and application of the funding principles contained in the Local Government Amendment Act (No 3) 1996 have led to ambiguous objectives and policies. This has resulted in a continuation of inequitable differential rating of the commercial sector. The de facto differential rate has avoided the politically uncomfortable consequences of applying the more efficient funding mechanisms contained in the Local Government Amendment Act (No 3) 1996.

1.11 Ratepayers are required to fund Council services provided to identifiable individuals, including non-residents, based on claims of illusory indirect benefits. Over 93 percent of the costs of library and information services, which are private services, are to be funded by rates. This implies that almost all the benefit from borrowing a book accrues to people other than the borrower. If that were the case why should anyone bother to use the library or care about what books they read?

1.12 We are reaching the view that the Council and some other major local authorities are incapable of initiating further necessary reforms and will have to be directed to do so by central government. The positive changes the Council has implemented have largely been in response to central government initiatives such as the 1989 reforms, the moves to set up LATEs and the 1996 legislation on financial management. We are asking the government to initiate a new round of policy changes to improve the efficiency of the local government sector. This is consistent with the call by the Organisation for Economic Cooperation and Development (OECD) in its recent report on New Zealand for "constant attention and ongoing – rather than stop-and-go reform" in areas such as local government if New Zealand is to achieve faster economic growth and higher living standards.

1.13 The balance of this submission is presented in three sections. The next section (section 2) contains comments on the draft annual plan. Section 3 examines Council businesses while section 4 draws the Council's attention to a recent report on local government.

## 2 Comments on the draft annual plan

### 2.1 Expenditure increases

2.1.1 The plan appears to propose a modest increase (1.3 percent) in total operating expenditure (excluding interest expense) and capital expenditure for the 1999/00 year compared with the 1998 approved budget. This could be misinterpreted as a fall in real terms, as both operating and capital expenditure budgets include a 2 percent allowance for inflation. However, a closer analysis reveals the plan proposes to lift operating expenditure, particularly on non-core activities, to a new plane.

2.1.2 The level of the underlying increase in operating and capital expenditure is not immediately apparent because of several factors. They include a temporary fall in capital expenditure from a record high, and the inclusion of an adjusted provision for depreciation and an allowance for inflation in the 1998 plan.

2.1.3 The increase in total operating expenditure (excluding interest expense) for 1999/00 is $10.5 million (or 4.8 percent). However, if the distorting effect of depreciation[1] is removed from total operating expenditure and if a further adjustment is made to the 1998 approved budget figures to exclude the allowance for inflation, the budgeted operating expenses for 1999/00 are $14.4 million or 8.9 percent higher than in 1998/99.[2]

2.1.4 The operating budgets for most activities are projected to increase by more than the assumed 2 percent inflation rate. Increases include 21 percent for sport and leisure, 18 percent for community services, 17 percent for environmental services, 16 percent for economic development, 9 percent for both public accountability and the library, 7 percent for the art gallery and 5 percent for parks. These are major increases. The increase in operating budgets is driven by the Council's desire to engage in a wide range of activities that are not the appropriate function of territorial councils (eg clean air, energy advisory services, law and order and social issues, and economic development). No analysis has been undertaken of the potential marginal net benefit to be gained from the relevant projects and/or consideration given as to how and why intervention will realise the stated objectives.

2.1.5 While capital expenditure for 1999/00 is budgeted to fall by $6.5 million compared with 1998/99, it is approximately $10 million higher than last year's forecast for 1999/00 of $83.2 million. (It is noteworthy that the 1994 draft plan projected a capital expenditure level of only $64.3 million for 1999/00.) The 1999 plan proposes an additional $64 million of capital expenditure ($12.8 million per annum) for the period 1999/00 to 2003/04. This is the third proposed substantial lift in the capital budget. The first was in 1994 with the introduction of the so-called enhancement projects while the second was in 1997 when additional capital spending of $150 million spread over five years was proposed.

2.1.6 The latest capital spending proposals may lead to greater spending in the future. First, they involve significant expansion of the Council's non-core activities. Secondly, based on past experience, the plan's forecasts are likely to understate the actual cost of capital projects scheduled for any given year (eg because of poor cost estimates, as occurred with the Cathedral Square project, and the constant addition of new projects). Thirdly, in formulating its long-term financial forecasts, the Council has not in the past had adequate regard to the medium- and long-term impact on operating budgets of its capital spending. The suspicion that the future consequences of spending decisions are not fully accounted for in the financial forecasts are accentuated by comments in the plan such as "the Council intends using interest earned on the proposed economic development fund to defray operating expenses and minimise rate increases".[3]

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1 Depreciation is an accounting mechanism for allocating 'past' capital expenditure to accounting periods. The depreciation provision in each year is taken into account in computing the level of rates because the decline in the service potential of assets is a cost incurred in producing goods and services.

2 1999/00 expenditure includes an allowance for inflation.

3 Christchurch City Council 1999 annual plan, p 8.

**2.2 Revenue increases and justification for rate increases**

2.2.1 Rates are budgeted to rise by $3.9 million or 3.2 percent. This is due to growth in the rate base and an increase in the level of rates of 1.96 percent.

2.2.2 The Council has no justifiable basis for increasing existing rates; in fact the evidence supports a significant reduction. First, ordinary revenues (including net interest) are forecast to increase by $13.2 million or 6.1 percent in the budget year and between $7 million and $9.4 million for the rest of the forecast period. Excluding rates, ordinary revenues are budgeted to rise by $9.3 million in 1999/00, which is the equivalent of a 7.8 percent increase in total rates.

2.2.3 Secondly, the last two plans have announced capital repatriation from LATEs of $230 million. Conservatively, they should generate and/or save interest of around $10 million per annum, which is the equivalent of an 8 percent rise in rates.

2.2.4 Thirdly, the plan budgets for interest and dividend payments from Christchurch City Holdings Limited (CCHL) of $23.9 million which is $5.3 million higher than the amount forecast for 1999/00 in the 1998 plan. In addition, the 1999 plan claims the Council has found efficiency savings of $2.4 million. These unexpected revenue gains and cost savings are equivalent to a rate increase of 6.4 percent.

2.2.5 Fourthly, the approved budget for the current financial year contains a 2 percent provision for inflation, the value of which is estimated to exceed $5 million. However, inflation for the year ended March 1999 was -0.1 percent. If the Council is in control of its expenditure it should underspend its 1998/99 budget by around this amount.

2.2.6 The combined impact of all the unforeseen factors that have given rise to increases in operating revenues and cost savings appears to be equivalent to an additional $23 million per annum, or a 19 percent rise in rates.

**2.3 The plan's emphasis on rating**

2.3.1 The Local Government Amendment Act (No 3) 1996 (the Act) encourages councils to have greater regard to the efficiency of funding arrangements and to move away from excessive reliance on rates. However, the plan proposes a reduction in Council funding from user pays revenues in favour of rates, namely, from 37.5 percent in 1998/99 to 36.5 percent in 1999/00.

2.3.2 The Council's decision to invoke section 122G to block a potential 8.2 percent fall in the commercial rate is arguably a misuse of the provisions of the Act. The need for the resolution to modify "significant adjustment difficulties"[4] was generated by the Council's excessive spending in the past and a desire to substantially lift real expenditure over the next five years.

2.3.3 The Council's rating policy has imposed unjustified cost on the commercial sector and undermined its profitability. The plan shows that $20.3 million of 'direct' benefit is to be reallocated to the commercial sector for the 1999/00 year. This amount is to be funded by rates on the commercial sector bringing total allocations to the sector to $43.9 million.[5] This impost reduces profits, investment and employment opportunities in export and import-competing industries which are unable to pass on higher rates by increasing their prices. While firms producing for the domestic

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4 *ibid*, p 16.

5 At the time of the last budget, business groups argued that the Council had incorrectly and unfairly applied the funding principles in deriving the initial $23.5 million allocation of cost.

market may be able to raise prices, the Reserve Bank would be forced to respond by tightening monetary policy and raising interest rates, given its inflation target.

**2.4 Economic development and employment**

2.4.1 The Council is proposing to establish an economic development fund of $41 million. The purpose of the fund is "to build real long term jobs in Christchurch and Canterbury".[6] The fund will be additional to existing economic and development subsidies ($11.5 million in 1999/00).

2.4.2 This proposal, in combination with current rating subsidies, highlights the incoherent and interventionist policies of the Council. On the one hand, the Council consciously undermines the commercial sector's profitability by imposing excessive rates (eg by passing a resolution to block implementation of the full effect of the change in the incidence of rates caused by revaluations, by its reluctance to apply efficient funding instruments, and by allocating almost all of the cost of road carriageway depreciation and road maintenance to the commercial sector). On the other hand, the Council wishes to administer subsidies to a number of privileged firms to try to alleviate the harm it inflicts on business.

2.4.3 Similar central government schemes that aimed to promote economic development by picking winners imposed huge costs on taxpayers and those who were denied a job elsewhere in the economy. The Council has no expertise in these matters and is incapable of determining which industries are likely to succeed or fail. It is inappropriate for the Council to fund irrigation schemes, technology centres or other private sector investment activities, or to favour one economic activity or project over another. A subsidy for one firm requires a corresponding tax to be imposed on another firm or ratepayer. A more effective strategy is for the Council to focus on its core activities and ensure that its regulatory and funding regimes do not impose unnecessary costs on the local economy.

**2.5 Operating surplus**

2.5.1 The plan announces a change in policy on operational surpluses (ie the difference between total annual operating revenue and expenditure). A surplus is generated by striking rates at a level that is higher than that required to balance revenue and expenditure. While a small surplus may be justified to provide for unforeseeable events, the level of the surplus and its proposed purpose cannot be endorsed.

2.5.2 From a small operating surplus of $0.7 million in the current year, the new policy is to increase it to $3.5 million (ie equivalent to 2.8 percent of rates) in 1999/00 and $13.9 million (ie equivalent to 7.8 percent of rates) in 10 years' time.[7] The increased surplus in the budget year requires the equivalent of a 2.2 percent increase in total rates. The abandonment of this policy alone would alleviate the need for a rate increase.

2.5.3 The Council states that the purpose of the surplus is to fund the purchase of capital assets and thereby assist in the reduction of borrowing. However, the policy of funding new assets from surpluses is contrary to (inter-generational equity) funding principle (a) of section 122F of the Local Government Amendment Act (No 3) 1996. This principle states "that the costs of any expenditure should be recovered at the time that the benefits of that expenditure accrue". The Council's policy requires today's ratepayers to fund assets for the benefit of tomorrow's generations. The change in policy is inequitable

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6 Christchurch City Council, *op cit*, p 8.

7 *ibid*, p 12.

**2.6 Economic development fund**

2.6.1 The Council proposes to establish an economic development fund. It infers that it would be inappropriate to refund any of the capital proceeds from the sale of Southpower directly to ratepayers. The plan states that the assets were built up by generations of Christchurch people and therefore they should be invested for the benefit of future generations. This is not an argument for the Council to retain the funds for this purpose. It is like arguing that former mutual life companies such as AMP should not have demutualised because the value of the existing business was created by past policyholders.

2.6.2 The relevant issue is how the overall welfare of citizens can be maximised going forward. This can be achieved by giving the proceeds to ratepayers, along the lines of life insurance industry demutualisations. Any paternalistic suggestions that the Council knows the diverse preferences of its citizens better than individual citizens are fanciful. Westpower Trust distributed to electors the proceeds from the sale of its energy trading/generation activities to Trust Power. All electors in the Westland District received $2,150 each (around $4,000 to $6,000 on average per household) from the proceeds of the transaction. The distribution of the funds directly to ratepayers is a legitimate, justified and more efficient option than the establishment of a development fund. Any view that ratepayers would not use such funds wisely, either for consumption or investment, is elitist and arrogant – if valid, the logical conclusion would be that councils should deprive citizens of even more disposable income by increasing rates still further and spending the proceeds on their behalf.

**2.7 Housing**

2.7.1 The Council's housing policy aims "To contribute to the community's social well-being by ensuring safe, accessible and affordable housing is available to people on low incomes including elderly persons and people with disabilities". The opportunity cost of ratepayers' investment in housing is the main cost of the policy. The provision of housing is a private activity. The great majority of New Zealanders, including people on low incomes and older people, live in private accommodation. There are no impediments to the supply of housing for single men, mature single women, women with one child or older people that justify Council provision of housing as provided in the policy. The change in emphasis in central government's housing policy from the provision of rental accommodation to the payment of the accommodation supplement reflects this view.

2.7.2 Housing is too expensive for some people. In these circumstances central government and councils should examine whether their regulatory activities unduly increase the cost of housing, for instance by restricting the supply of land for urban development. Beyond this, the issue is one of inadequate income which affects the ability to acquire food and other goods and services as well as housing. Income supplements are generally a more effective means of addressing income inadequacy than the provision of housing. There are bound to be people accommodated privately who face at least as much hardship as some people who are subsidised through the Council's housing policy. The provision of income transfers is a central government function. The Council should follow the lead of some other councils and exit from the provision of housing provided for people on low incomes. Its actions impose a burden on ratepayers which would otherwise be met in large part by taxpayers through the accommodation supplement. Council housing should be limited to emergency accommodation or special cases such as people with psychiatric problems.

## 3 Council businesses

3.1 The key arguments for privatising council-owned businesses are listed below:

- On average and over time, publicly owned businesses perform less well than private businesses. This conclusion rests on substantial empirical evidence from many studies. It means that the financial returns from publicly owned companies are poorer on average than those of privately owned businesses and that (leaving aside issues of monopoly which are addressed below) the economy operates less efficiently and generates less wealth for the community.

- Public ownership of enterprises is an inferior response to the control of monopoly than strategies for enhancing market competition and applying anti-trust regulation as provided in the Commerce Act 1986. Moreover, issues of monopoly do not arise in relation to most of the Council's businesses.

- The Council has no special expertise in the management of forestry, ports, airports, energy distribution and passenger transport in which it is engaged.

- Like all public sector organisations, council-owned businesses suffer from relatively weak financial accountability. Wholly council-owned companies, for instance, are not subject to monitoring by participants in capital markets.

- The directors of companies that are partly owned by the Council are required to act in the best interests of the company. Council-appointed directors cannot lawfully pursue wider public objectives that are inconsistent with the interests of the company. If LATEs were to pursue such objectives they would be in breach of their statutory requirement to operate as successful businesses.

- The Council does not need to own businesses to fund its spending. It should apply user charges where appropriate and fund the balance of its spending from rates. They are transparent funding sources and they better enable the Council to be held accountable for its spending decisions.

- Some ratepayers have limited incomes and face few choices. They struggle to pay for necessities such as food and housing. They should not be forced to bear undiversified and unnecessary risk and higher rates than otherwise to enable the Council to invest in commercial activities. If ratepayers wish to invest in forests, ports, airports, energy distribution or passenger transport they can choose to do so privately.

3.2 The Council should sell its interests in Selwyn Plantation Board Limited. Investment in forests is not an appropriate public sector activity, as central government's decision to sell its interests in forests demonstrates. The argument that now may not be a good time to sell is wrong. Potential buyers will make their assessment of future prices for wood. They would also take into account the potential for efficiency gains. In a competitive process both factors would be reflected in the purchase price offered to the Council. The Council should commission a scoping study for the sale of all its interests in Selwyn Plantation Board Limited.

3.3 The Council should also sell its 65.6 percent holding in Lyttelton Port Company Limited. Port services are a private activity and not a public good. They do not give rise to monopoly issues; the Company has itself stated that it faces strong competition for its services. The Company is listed on the stock exchange and its directors are required to act in the Company's best interests. Port operations in New Zealand will need to be rationalised in response to changes in the industry and patterns of trade. Public ownership of ports is likely to impede such rationalisation to the detriment of exporters and importers.

3.4 The Council should exit from Orion Group Limited. There can be no plausible justification for the Council to invest in a business that (among other things) distributes gas in the North Island. Such assets cannot be of any strategic significance to Christchurch ratepayers. Orion's electricity business is subject to high commercial and regulatory risks as demonstrated by the forced sale of the Council's retail electricity business last year and the current prospect of price control. Any concerns about the control of monopoly are best addressed through the Commerce Act 1986.

3.5 The Council should sell its 75 percent holding in Christchurch International Airport Limited, possibly in conjunction with the sale of the Crown's minority interest. The provision of airport and related services is a private activity. There are no monopoly issues that justify public ownership. There has been extensive privatisation of airports in New Zealand and elsewhere. Australia, for instance, has privatised its main airports with the exception of Sydney. The *Australian Financial Review* of 27 April 1999 reported that a study by the Australian Competition and Consumer Commission found that the main privatised airports in Australia reduced aeronautical charges by an average of 3 percent in 1997/98, the first full year following their privatisation. Furthermore, customers were generally satisfied with the quality of airport services.

3.6 The Council should also sell Redbus Limited. The provision of passenger transport is a private activity. Publicly owned bus operations in the Auckland region and Wellington have been sold, providing lower prices and better services for commuters.

3.7 If the Council were operating as an investment portfolio manager on behalf of ratepayers and was concerned to get the best possible returns for a given level of risk, it would quit its existing investments and put the funds in a globally diversified portfolio. Having the bulk of its funds tied up in infrastructure investments in the Canterbury region is a low value and unbalanced strategy. However, there are no grounds for the Council acting as a manager of involuntary investments made by ratepayers. Individual ratepayers should be allowed to determine the type and level of investment risk they are prepared to bear.

3.8 We submit that Council businesses should be sold and the proceeds should be used to reduce debt (future rates) and/or be returned to ratepayers. The Council should concentrate its efforts on discharging its core public goods functions well.

## 4 Refocusing the Role of Local Government

4.1 Finally, we commend to the Christchurch City Council the report *Refocusing the Role of Local Government* released by the Local Government Forum earlier in 1999. The report provides a detailed discussion of the core role of local government. It examines how local government should fund its activities, gives reasons for abolishing differential rating and presents the case for councils to exit from the ownership of businesses.

THE BUSINESS NETWORK

# TOWARD MORE EFFICIENT AND DEMOCRATIC LOCAL GOVERNMENT

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# TOWARD MORE EFFICIENT AND DEMOCRATIC LOCAL GOVERNMENT

The Organisation for Economic Cooperation and Development's (OECD's) recent report on the New Zealand economy makes salutary reading. It says that the overall economic strategy that has been evolving since the 1980s "appears to be on the right course". On the other hand, it correctly notes that economic outcomes have not improved as much as hoped. Its key message is the need for "constant attention and an ongoing – rather than a stop-and-go – reform effort". It calls for "follow through on microeconomic reforms" in certain areas including local government, where "reform has not been as extensive as elsewhere".

The New Zealand Business Roundtable has expressed similar concerns. It endorses the OECD's call for further reform of local government. The efficiency of the sector must be raised substantially, and more transparency and accountability are required to make it more democratic.

Some people like to claim that the Business Roundtable is opposed to democracy and will not rest until every conceivable issue is left to the market. Nothing could be further from the truth. We have always recognised that some issues need to be resolved collectively through the political system. Our founding statement of purpose affirms that:

> An important role for the government is seen in providing a sound framework of laws and a macroeconomic environment which facilitate private sector decision making, and in undertaking certain activities which are best catered for within an efficient public sector. The government also has responsibility for necessary action to modify market outcomes in the distribution of wealth or income, and to pursue other social equity objectives in a well-considered and cost effective way.

Both the market or, more correctly, voluntary exchange, and democratic government have limitations as mechanisms for enabling people to get what they want. Cases of market failure are known to any economics student. They can occur with public goods, where non-payers cannot be excluded from benefiting from goods or services; with externalities, where significant costs and benefits fall on parties other than those directly involved in a transaction; and with monopoly, where there can be abuse of a dominant position. Market failures may justify government intervention.

On the other hand, government failure is commonplace and in many ways more difficult to remedy than market failure. Winston Churchill stated that "democracy is the worst form of government except all those other forms that have been tried from time to time". Voters have little incentive to become informed because a single vote carries little weight. They have to vote for a package of policies, many of which they may not like. Politicians are like people in other walks of life: they tend to be self-interested. They often act in ways that enhance their position or their party's interests, rather than in the public interest. As a consequence, organised groups lobby for policies which benefit them in return for supporting a politician or party, and unorganised groups such as consumers, taxpayers and ratepayers end up meeting the costs. The political system is much less efficient at revealing information than the market. It is virtually impossible to determine the real preferences of people unless they freely exchange one thing, for instance an amount of money, for another. Politics is a highly imperfect mechanism for making social choices.

The choice between imperfect political decision making and imperfect markets therefore depends on which does the best job in a particular circumstance of maximising overall community well-being. If markets were perfect we would not need governments, and vice versa. Both mechanisms have to be used, but we need to be aware of the comparative advantages and disadvantages of each.

Consistent with this view, the Business Roundtable holds that local government has a vital role to play but its role (and that of other levels of government) is not all-encompassing. It needs to be established on a principled basis and properly circumscribed. Our argument is not for no government or minimal government but for government of the right shape and size. The core business of local government should be funding and – in justifiable circumstances – providing local public good services which cannot be better provided by firms, households and non-profit organisations. Local government also has a role administering necessary local regulations.

Councils serving rural areas, such as Opotiki and the Taranaki Regional Council, are generally focused on their core business, although some like the Far North District Council have had flights of fancy. However, with few exceptions, such as Papakura and Rodney, and more recently Hutt City, councils in the main urban areas continue to engage in a wide range of activities that should be left to the private sector or central government. Christchurch has had a particularly unfocused council in recent years. Some councils have neglected their traditional activities, such as roading, sewage disposal and drainage, to such an extent that inadequate services are limiting growth and development. The economic costs of the mismanagement of the roading infrastructure in Auckland are huge.

Since 1984 most legislative changes affecting local government have been of the enabling type, conferring wide discretion on local authorities. However, no major reforms affecting local government have been initiated and led by the sector. Councils have generally opposed greater private sector participation in key areas such as water supply, drainage and sewage disposal, despite substantial evidence of the benefits.

Local authorities have seldom taken a principled approach to reviewing their activities. Sound economic principles were reflected in the government's initial proposals on financial management. The local government sector was responsible for gutting them. Local Government New Zealand successfully lobbied to water down the principles and gave councils the opportunity to ignore them. Not surprisingly, the results to date of the Local Government Amendment Act (No 3) 1996, which contains the financial management regime that was eventually adopted, have been disappointing.

These developments suggest that central government needs to revisit the legislative framework for local government. The role and functions of local government need to be more closely specified. In setting up reviews of roading and water services, central government has recognised that it must drive rationalisation in the sector, and these should lead to a wider review of local government's other functions.

The roading and water reforms are likely to reduce the activities of local government, particularly district councils, over the medium term. Not surprisingly, some in local government are now trying to stimulate a debate on the devolution of functions from central to local government. They are doing so under the rubric of local democracy.

Carol Stigley, the chief executive of Local Government New Zealand, has put forward such an argument for devolution. In February 1999 she noted that local government spending in New Zealand accounted for 10 percent of total government spending and was much lower than in countries such as Finland, Norway and Denmark, where the ratio is between 28 and 52 percent. But unlike a number of European countries, New Zealand does not deliver health, education and welfare services through local government. This goes a long way towards explaining the lower ratio in New Zealand.

The distribution of functions between central and local government should not be designed to achieve some arbitrary split of total government spending. Three main principles should determine whether the funding and/or supply of particular public goods and services should be the responsibility of central or local government.

The first relates to informed decision making. The information required to make decisions is costly to obtain. Thus the level of government that is most likely to possess the required information should generally be given responsibility for related decisions. Central government, for instance, is likely to be much better informed about national defence than local government. In contrast, a local authority should be better placed to make decisions about local parks.

The second principle concerns balanced decision making. Decisions should be made at the level of government where both the benefits and the related costs fall. The people of, say, Hamilton have a direct interest in the operations of its council and little or no interest in those of councils on the west coast of the South Island, but they are affected like all New Zealanders by the decisions of central government. It makes sense for ratepayers in Hamilton City and Westland District to bear the costs of their own councillors and for the costs of members of parliament to be borne by all taxpayers. Trouble is sure to arise when one level of government is responsible for spending decisions while another is charged with raising the required revenue.

The third principle relates to cost effective decision making. Where the costs of making decisions are high and individual preferences are relatively uniform, national policies may be efficient. On the other hand, where preferences differ, local decision making may enable the diverse preferences of people to be better reflected. People who strongly favour, say, extreme environmental policies can locate in an area that reflects their preferences while others can locate elsewhere.

As things stand, the application of these principles on a case-by-case basis is unlikely to lead to any major reallocation of functions between central and local government. A generally sound division of responsibilities is already in place. There is no general support for major devolution and calls for new forms of local taxation have died away.

Proponents of devolution sometimes attempt to link their arguments with those of market advocates of decentralisation and federalism. The Nobel laureate James Buchanan, for example, has written about federalism in the context of the United States. It hardly needs pointing out, however, that the United States is a country with over 70 times the population of New Zealand.

Federalism is intended to operate in much the same way that competition in a market encourages firms to act in the interests of consumers. If citizens can leave their country or state, the prospect of doing so will constrain a government from extending its control over them. The economic cost of moving to another state may be lower than that of migrating to a foreign country with different institutions and customs. Constitutionalists like Buchanan advocate the division of political authority between levels of government, such as between federal and state governments in the United States and between the European Union and its sovereign states. Buchanan's overriding concern, however, is to limit the role of government at all levels. As he put it in concluding a 1993 paper entitled 'The Liberal Constitution':

> I have not addressed issues such as republican versus parliamentary forms of government; proportional representation versus two-party structures; [and] effective federalism versus political centralisation. But my neglect of such issues has been quite deliberate. All such organisational-procedural matters fade into insignificance by comparison with the constitutional challenge of placing constraints on the authority of government over the operation of the economy.

Similarly, we should not allow a debate about devolution to divert attention from the overriding goal of refocusing local government on its proper role.

Another strand in the debate on local democracy relates to whether local government is more democratic and responsive than central government. Carol Stigley argues that:

> The current emphasis in public policy on the transfer of responsibility for former public services from the 'mandarins' within the bureaucracy to 'mandarins' within the private and corporatised public sectors does little to increase diversity or the capacity of communities for self-government.
>
> The resulting democratic deficit is seen by many in the communities local government represents as eroding civic life, removing decision making from the public sphere, and placing it in the hands of new structures, which are equally distant and unresponsive.
>
> 'Government' may be becoming smaller. But to many of the ratepayers and residents our branch of the public sector works with, it seems like more decisions being made by centralised agencies, and fewer opportunities to influence policy and services.

These comments do not acknowledge that there are valid limits to the role of the government. Taking any activity out of the public sector appears to be seen as undesirable, regardless of whether it should have been in the private sector in the first place. Constitutional advocates of limited government would view a reduction in the production of private goods by the public sector as a desirable advance in freedom and efficiency. Carol Stigley confuses a reduction in socialism – less public ownership of businesses – with a reduction in democracy.

The implication that the government is becoming smaller is also mistaken. The best measure of the size of government is the level of its spending relative to gross domestic product (GDP). Total spending by governments – central and local – in New Zealand is estimated by the OECD to reach 41.4 percent of GDP this year, up from a low point of 38.5 percent in 1997. At a time when we are seeing double digit rate rises, not even Local Government New Zealand would be so brazen as to suggest that local government spending is shrinking.

In a research paper prepared for Local Government New Zealand, Peter McKinlay reported that "in many areas, local authorities are now seeing themselves as, at the very least, advocates on behalf of their communities". He noted that in areas that have traditionally been the responsibility of central government and where local authorities may have no financial obligations, they are "increasingly claiming a right on behalf of their communities to be partners in the process of working through options".

According to Local Government New Zealand, an opinion survey shows that local government is "more accessible, more willing to listen and more responsive to public opinion than central government". The results of the survey should, however, be regarded as deeply disturbing. Only 25 percent of respondents considered that the average person has considerable influence on local government (and a still smaller percentage thought that they had a similar influence on central government).

In the understatement of the year, Local Government New Zealand reported that "the significant number of respondents who disagreed with [the statement that the average person] has considerable influence on local government shows there is still a big gap between perception and reality". But arguably the majority of respondents (up to 75 percent) have it right and it is Local Government New Zealand that is detached from reality.

Local government often poorly reflects the views of the community. In a candid observation, the mayor of Hutt City, John Terris, said that a fifth of his city's population comprised Maori, Pacific Islanders and Asians but "there wasn't a single brown face" on the council. There is minimal public participation in most consultative exercises undertaken by local authorities. A survey by the Department of Internal Affairs found that councils on average received only 160 submissions on their annual plans in 1994/95. Fewer than 20 submissions were received on the draft annual plan of the Auckland Regional Services Trust, a billion dollar business, in 1997. Mayors privately admit that consultations on plans are a charade, involving largely a parade of vested interests seeking additional spending on their pet projects. Groups representing the business sector, which has little voting power, are rarely listened to. For that reason we have decided that a detailed examination of city plans for 1999/00 is a waste of effort.

Last year the Business Roundtable argued that the citizens of the Auckland region should be allowed to decide by referendum whether assets such as shares in Ports of Auckland Limited held by the Auckland Regional Services Trust should be distributed to ratepayers. Local body politicians in Auckland campaigned vigorously and successfully to ensure that their citizens did not get such an opportunity. One might ask which party is more committed to democracy.

The problems of local government stem from weak accountability. There is a low turnout at elections, usually no more than 50 percent, despite postal voting. Few voters can identify more than a handful of candidates on ballot papers. Often candidates do not have a party affiliation, so there is not even a party platform to help voters make their choice. Mayors and chairpersons do not necessarily lead the political party or parties with a majority on a council or command the support of a majority of councillors. As a result they are sometimes unable to implement the manifestos on which they were elected. Governance and management roles on councils are often confused. Media coverage of local government affairs tends to be sparse and unquestioning relative to that of central government. The operations of many councils are not transparent, and they are difficult to monitor because of the vast range of activities councils engage in.

At the staff level, many council officers are not competent to provide quality public policy advice to councils. More attention is paid to the quantity of submissions for or against a project than to the quality of the arguments. In the case of the Christchurch City Council, for example, those responsible for financial management have consistently got basic aspects of financial analysis wrong. Staff on the Wellington Regional Council use outdated economics to justify subsidies to public transport. The Controller and Auditor-General's Report on the management of Auckland's Britomart project, which includes the construction of a bus and train terminal, confirmed that the transport aspects of what could become the biggest local body project ever undertaken in New Zealand had not been subjected to a comprehensive cost and benefit analysis. Not only was this finding not sufficient to lead to the view that the management process was flawed, it passed virtually unnoticed when the report was released. The mayor of Auckland City, Christine Fletcher, examined the performance agreement of the council's chief executive on her first day in office. She reported that the agreement "had 52 clauses in it and that it was indicative of the whole place. Fabulous people, everyone really well-meaning, but nobody focused".

The politics of local government have been perfectly illustrated over the past 12 months. Last year, a local government election year, rate increases were typically low. This year many councils are proposing double digit rate increases. How many candidates standing for councils last year did you hear saying 'Vote for me and I will put your rates up by 10 or 20 percent'?

Some councillors have blamed the proposed rate increases on a legislative requirement to provide for depreciation. That is a feeble excuse. If councils had acted responsibly in the past and made provision for depreciation like any well-run business, the implementation of the new legislative provisions would have made no difference. It was the failure of some councils to provide for depreciation in accordance with accrual accounting rules introduced in 1990/91 that led to legislation explicitly requiring councils to provide for depreciation. That legislation was passed three years ago. The whole saga is evidence of the chronic problems of much of the local government sector.

Council spending is excessive and is increasing. It is a major reason why some councils, such as Auckland and Wellington, are putting up rates. Few ratepayers can possibly believe that the quality and quantity of services they receive have increased commensurately. The Wellington Regional Chamber of Commerce is so exasperated with the performance of the Wellington City Council that it is calling for a commissioner to be appointed to take over and run it.

As the OECD indicated, the problems of local government are a serious national issue. A new round of policy initiatives is required. They must be initiated and driven by central government as in 1989, when central government acted decisively after years of tinkering with the problem had come to nought.

Activities such as the provision of water and roading infrastructure should be commercialised. Local authorities should be required to focus on the public good activities that are the proper business of government at the local level, and prohibited from engaging in the provision of private goods and services. The Local Government Amendment Act (No 3) 1996 should be revisited to ensure that councils apply sound economic principles in deciding what activities to engage in and how their spending should be funded. The flawed Resource Management Act 1991 should be examined afresh.

Large councils that are remote from ratepayers are a major part of the problem. Thus simply amalgamating territorial authorities is not a basic solution. However, following the roading reforms, some small district councils may need to merge with neighbouring ones to remain viable. The need to retain separate regional councils should be examined, and special purpose authorities, like Infrastructure Auckland, that have no valid purpose and are not accountable to ratepayers, should be abolished.

These steps would reduce the size of council activities substantially, make their activities more transparent, facilitate better monitoring by ratepayers and result in lower rates and regulatory burdens. They would make councils more democratic. Central government should also take a much more active role in monitoring the performance of local government.

The current fundamental weaknesses must be addressed in the interests of moving towards a more efficient and democratic local government sector. Until this happens, New Zealand's economic and social performance will continue to fall well short of its potential.

# INDUSTRY POLICY AND REGULATION

**NEW ZEALAND BUSINESS ROUNDTABLE**

# SUBMISSION ON THE DAIRY INDUSTRY RESTRUCTURING BILL

**AUGUST 1999**

## Summary and Conclusions

- This submission on the Dairy Industry Restructuring Bill 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 submits that the Dairy Industry Restructuring Bill combines a step forward in dairy industry reform with an unnecessary leap backward in the corporate structure of the dairy industry. Removal of the Dairy Board's statutory monopoly over the export of dairy products made in New Zealand is a positive step that is long overdue. But the beneficial impact of this step on the New Zealand economy is likely to be negated, possibly for more than a decade, if the proposed establishment of a giant cooperative (Mega-coop) comes to fruition under conditions which would prevent farmers from exiting with the full value of their shares.

- Considered as a package, the proposals in the Bill are likely to have a net positive impact on the economic welfare of New Zealand. However, in the light of its stated objective "to maximise" the economic welfare of New Zealand, the government should be aiming for a much higher quality result than an improvement over the status quo. The NZBR considers that a much better result can be achieved by leaving unnecessary elements out of the package.

- The requirement in the Bill that makes the removal of the Dairy Board's statutory export monopoly conditional on the merger of dairy cooperatives is not necessary. This requirement would be logical only if there was reason to believe that such mergers are self-evidently in the national interest. The government should not be determining or sanctioning the structure of the dairy industry. In fact, there are strong grounds to argue that the current proposals for establishing Mega-coop would be detrimental to overall New Zealand interests. New Zealand would end up in the unique position of having as its largest company a cooperative entity. These proposals would put Mega-coop in a privileged position relative to potential competitors. Most importantly, they would permit Mega-coop to impede the access of competitors to milk supplies by denying its shareholders the right to exit with the full value of their equity. As well as impacting adversely on the economy, this would infringe the liberty of shareholders of existing dairy cooperatives.

- The case for the removal of the Dairy Board's export monopoly is not conditional on the emergence of any particular industry structure. This reform should occur without further delay in order to:

  - expose firms engaged in the processing and marketing of New Zealand dairy products to the normal competitive processes that promote innovation and efficient use of resources;

  - encourage cooperatives to abandon inefficient practices such as the bundling of returns from off-farm investment in payments for milk;

  - make it possible for new entrants (including investor-owned firms or foreign firms) to engage in the processing of New Zealand milk to meet international demand rather than using milk supplies from other countries;

  - encourage the entry of additional capital into the industry; and

  - encourage existing processing and marketing firms to establish improved international linkages that will enable them to take better advantage of opportunities to supply goods that consumers in other countries want.

- The public benefits that proponents claim will flow from establishing Mega-coop are largely fictional. Some of these alleged benefits do not actually depend on the proposed mergers. Others are based on an improbable account of possible future developments in the dairy industry, assuming that the removal of the Dairy Board's export monopoly is not accompanied by the formation of Mega-coop.

- There are grounds for scepticism about the proposed safeguards to prevent Mega-coop from having market power that could be used to the detriment of domestic consumers. The most effective safeguard for consumers, as well as for farmers, would be to ensure that Mega-coop's competitors are able to develop their own supplier base, without being impeded by the inability of farmers to exit from Mega-coop with the full value of their equity.

- The fact that Mega-coop would be owned by its supplier members would not prevent its dominance of the market for unprocessed milk being used to the detriment of some or all farmers. This is because of factors such as:

  – the unclear and ambiguous objectives that usually make the management of cooperatives more difficult to monitor than the management of investor-owned firms;

  – lack of transparency in reporting returns on investment to shareholders;

  – lack of incentive for people such as financial market analysts and investment fund managers to monitor the performance of the firm because of the restriction of share ownership to farmer suppliers;

  – the inability of suppliers to recoup the potential value their shares would have in an unrestricted market if they were to decide to supply milk to a competitor to Mega-coop.

- If Mega-coop is able to use its dominant position to discourage farmers from supplying potential competitors, this is likely to be detrimental to the development of the dairy industry and growth of the New Zealand economy. Eventually, the weight of its own inefficiency would be likely to become so great that Mega-coop would no longer be able to impede the growth of competitors. However, New Zealand does not need any additional impediments to economic growth, even in the short term.

- The NZBR supports the general thrust of the proposed arrangements to maximise the economic benefits from access to foreign markets in which New Zealand exports are limited by country-specific import quota. However, there are grounds for concern about some of the relevant proposals. In particular, the protracted transitional period before the proposed licences will be allocated competitively is unwarranted. Delaying the competitive allocation of licences is likely to give Mega-coop further potential to subsidise itself at the expense of dairy farmers.

## Recommendations

1 The statutory powers providing for a single desk exporter for New Zealand dairy products should be removed forthwith.

2 Special provisions should apply to designated markets in which New Zealand exports are limited by country-specific import quota. The Dairy Board (or the new marketing company referred to below) should retain exclusive rights to export to these designated markets for a period of 12 months. Thereafter, licences to export to these designated markets should be allocated by the "allocation body" proposed in Part 2 of the Bill, with a view to maximising the sustainable value of these licences for

the benefit of its shareholders. The Act should specify that shares in the allocation body are to be fully tradeable, rather than "tradeable as provided for in its constitution", as stated at present in section 19(d).

3 The Dairy Board should be converted into a company, with shares initially allocated to dairy cooperatives in proportion to their share of total milk solids supplied to the Board. The Act should specify that shares in the new marketing company are to be fully tradeable without any restriction on ownership.

4 The Act should ensure that the laws that apply to companies and cooperatives in the dairy industry in New Zealand will henceforth be the same as those that apply generally to companies and cooperatives in other industries in New Zealand.

## 1.0 The logic of the proposed changes

1.1 The Dairy Industry Restructuring Bill seeks to make a reform that is long overdue – removal of the Dairy Board's statutory monopoly over the export of dairy products from New Zealand – conditional on the amalgamation of a number of dairy cooperatives. This would result in the domination of the industry by one processing and marketing cooperative (Mega-coop).

1.2 Why is the government continuing to involve itself in determining corporate structures in the dairy industry? In terms of normal public policy criteria, this makes sense only if it has reason to believe that a particular corporate structure is so strongly in the national interest that any other outcome should be discouraged. This is implausible.

1.3 Even if the government believes that "the critical mass necessary for successful global operations" may make it advantageous for a single firm to be responsible for a high proportion of New Zealand's dairy product exports, this does not explain why reform should be conditional on the emergence of Mega-coop. The government could ensure the continuation of the alleged benefits associated with the scale of the Dairy Board's operations merely by making the legislative changes necessary for it to continue as a public company with freely tradeable shares. If the new company provides greater benefits to the major shareholders (New Zealand Dairy Group (NZDG) and Kiwi) than alternative arrangements, it is likely to continue to dominate export sales of New Zealand dairy products. If the shareholders of the new entity wish to merge, that is a matter they can decide for themselves, subject to Commerce Commission approval, in the same way as firms in other industries make such decisions.

1.4 The most straightforward explanation for the provisions in the Bill which make reform conditional on establishing Mega-coop is that they may facilitate the emergence of the corporate structure desired by major players in the industry. Perhaps the government's endorsement of Mega-coop is intended to allay the fears of farmers that further amalgamation of cooperatives may not serve their interests. However, the endorsement of Mega-coop implied by the Bill does not displace Commerce Commission consideration of the proposed merger. The Act will not take effect unless the cooperative amalgamations have been authorised by the Commerce Commission.

1.5 Would Commerce Commission approval of the proposed merger guarantee that it is in the public interest? It is arguable that the public interest issues involved in this matter extend beyond the considerations which governments normally place in the hands of competition regulators. The government should be particularly concerned about the potential for freedom of entry and exit to be compromised in a market dominated by a cooperative.

1.6 There are very real questions not resolved in the Bill as to the ability of landowners, who will be shareholders of Mega-coop, to shift their business to other potential purchasers of milk supplies without incurring substantial financial penalties.[1] This might not be a matter of concern from a public policy perspective if individual members were to enter into long-term contractual arrangements with Mega-coop, knowing that they might not be able to recoup the full market value of their share of the capital upon exit. But membership of Mega-coop is to be decided collectively (by votes taken by members of existing dairy cooperatives) rather than through a process which would give individual members the option of recovering the full value of their investments prior to the formation of Mega-coop.

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1 Sharemilkers would not suffer such a penalty and so would presumably be much less reluctant to shift their business.

1.7 Although proponents of Mega-coop have suggested that farmers who wish to exit will be provided with compensation greater than the nominal value of their shares, they have not revealed how this compensation will be determined. The most obvious method of compensation – by making it possible to sell shares in an unrestricted market – will not be available. The Bill does not require full tradeability of shares and proponents of Mega-coop have indicated that they envisage that tradeability will be severely restricted, with ownership of shares being linked to supply of milk.

1.8 It is not valid to argue that membership of existing cooperatives has involved a choice to accept the potentially adverse consequences of restrictions on transferability of ownership rights that this involves. The Dairy Board's statutory monopoly on exports has prevented the emergence of investor-owned competitors that would have given farmers the choice of supplying milk without investing in off-farm processing and marketing activities.

1.9 The following comments made last year by minister for agriculture Lockwood Smith are highly relevant to this question:

> Once ownership is established, we will need to consider how to allow farmers to exit from their current marketing organisation, while retaining their capital. In other cooperative organisations, from the local tennis club to far more complex commercial operations, it can be difficult or impossible for people to exit with their capital. The difference is that those involved in such organisations have had a choice about whether to be involved in the first place. It may be that that choice could be exercised at the time of transition to a deregulated environment. Careful consideration will need to be given to this issue.[2]

Unfortunately, this issue does not seem to have been given sufficient consideration in the drafting of the Dairy Industry Restructuring Bill. Rather than protecting the rights of farmers who wish to surrender shares in Mega-coop, the Bill leaves this issue to be determined by the constitution of Mega-coop. The Bill provides (Clause 10) only that the new cooperative may include in its constitution a provision that entitles shareholders surrendering shares to the fair value of those shares. Some press reports suggest that there is a strong possibility that shareholders wishing to exit from Mega-coop will not receive anything like the value those shares would fetch in an open market.[3]

1.10 It is difficult to imagine how the government could justify its endorsement of Mega-coop in terms of a set of principles that it would wish to apply to all sectors of the New Zealand economy. Members of Parliament, in particular, should pause to consider whether encouraging the establishment of mega-coops is consistent with basic principles concerning protection of personal liberty. Personal liberty is not some nebulous concept that is far removed from practical policy considerations. In the real world, personal liberty is closely linked to freedom of entry into and exit from markets. This has been explained succinctly by Richard Epstein, Professor of Law at the University of Chicago, as follows:

> In a nation containing many separate individuals, the counterweight to the arbitrary power of one person is the ability of each to shift his or her business, custom or friendship to other people. Given free entry and free exit from various markets, it is that range of choice which offers the

2 Dr the Hon Lockwood Smith, 'Producer Board Reform', address at Warkworth, 11 June, 1998.

3 For example, the article by Aimee McClinchy, 'Farmers want a better deal from Mega-Coop merger', *National Business Review*, July 23, 1999.

> securest guide to our liberty. Indeed that is how we each tend to envisage our own private liberty.[4]

## 2.0 The case for abolishing the Dairy Board's export monopoly

2.1 The case for removal of the Dairy Board's export monopoly is not conditional on the emergence of a particular industry structure. If there are sound economic reasons for New Zealand's presence in dairy export markets to be dominated by a single player, there is no reason to think that these economies cannot be achieved through normal competitive forces. Neither NZDG nor Kiwi have any incentive to set up a competing exporting organisation unless they see the potential thereby to achieve benefits for their shareholders which exceed the benefits they obtain at present from economies of scale and scope associated with the Dairy Board's operations. Similarly, if there are large gains to be had by selling product under existing New Zealand brands, firms trying to sell under other brands could only offer a competitive price for access to New Zealand product if they had access to some other form of competitive advantage.

2.2 The NZBR has long recommended the removal of restrictions on exporting of dairy products on the basis of substantial analytical work, including the ACIL report published as long ago as 1992.[5] The case for the removal of the single desk exporting restriction was summarised as follows in a more recent report commissioned by the NZBR:

> Maintaining the Dairy Board's existing export monopoly is damaging to the community's overall interests because it limits innovation, shields the Dairy Board from competitive pressures to improve its efficiency, constrains the industry's ability to attract capital, distorts price signals to dairy farmers through the bundling of returns to on-farm and off-farm investments, and constitutes a barrier to the international linkages that are necessary to take full advantage of opportunities to develop new processes, new products and new markets".[6]

2.3 The only legitimate argument that has been advanced in favour of the single desk export restriction has been to ensure that New Zealand is able to capture quota rents in a small number of foreign markets. These quota rents arise from price premiums that may be available on sales to those markets in which New Zealand exports are restricted by a country-specific import quota. These quota rents can be captured through proposals such as those contained in Part 2 of the Dairy Industry Restructuring Bill. It is certainly not necessary to establish Mega-coop to capture them.

## 3.0 Possible economic benefits of Mega-coop

3.1 Support for establishment of Mega-coop appears to be motivated, in part, by a belief that monopoly exporting confers some advantage by reducing competition between New Zealand exporters. The fallacy of this has been pointed out many times by different authors. Lewis Evans and Neil Quigley have recently made the point clearly, as follows:

> A monopoly exporter rules out competition among New Zealand exporters, but the true constraint on the ability to obtain higher returns is

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4 Richard Epstein, *Principles for a Free Society*, lecture given in Auckland under the auspices of the Centre for Independent Studies, March, 1999, p 2.

5 ACIL, *Agricultural Marketing Regulation*, report prepared for the New Zealand Business Roundtable, October, 1992.

6 W Bates, *The Dairy Board's Export Monopoly*, New Zealand Business Roundtable, October, 1997.

> the competition provided by the dairy product exporters of other countries.[7]

3.2 Proponents of Mega-coop have argued that there are substantial size economies in both production and exporting of dairy products. They have also suggested that a large firm may be able to extract a surplus from foreign consumers through price discrimination – for example, where brand loyalties have been established in particular markets.[8] But even if large firms have substantial advantages in processing and marketing of many dairy products, small firms are likely to be able hold their own in some segments of the market. Even for those products where scale economies are greatest, an industry structure in which a single firm exports a high proportion of New Zealand's production is not necessarily optimal because it is possible for firms that are engaged in international trade to draw supplies from more than one country. There may also be scope for firms to achieve economies by selling a range of products that meet particular consumer requirements, beverages for example, rather than specialising exclusively in dairy products.

3.3 The risk for New Zealand in linking the vast bulk of its dairy industry to a single firm is that, for a variety of reasons including severe capital constraints, it is possible that this firm may not be particularly successful in the international marketplace. The strategy may thus involve accepting a lower than market return on investment and the possibility of receiving a less favourable price for unprocessed milk than more successful international firms offer to preferred suppliers. Such an outcome would be detrimental to overall New Zealand interests as well as to the interests of farmers.

3.4 The industry submission seeking Commerce Commission authorisation for the establishment of Mega-coop contains estimates of public benefits and costs that are based on a report by the New Zealand Institute of Economic Research (NZIER).[9] The NZIER has based its estimates on two counterfactuals: the status quo, and a hypothetical situation where NZDG and Kiwi maintain separate marketing organisations to compete with each other in the international dairy market.

3.5 The first counterfactual, which the NZIER considers to have most relevance to the short term, is based on the assumption that if Mega-coop does not obtain Commerce Commission approval, the government will not be willing to remove the single desk seller arrangements. Although the present structure of the Dairy Industry Restructuring Bill lends some support to this assumption, it is grossly misleading to attribute the benefits that will arise from the removal of the single desk arrangement to the proposed merger. Parliament is able to remove the single desk arrangement at any time, independently of any mergers in the industry. The fact that the NZIER report has acknowledged that substantial benefits (of the order of $20 million per annum, which in our view is a substantial under-estimate) will accrue from the removal of the single desk arrangement is an additional reason for Parliament to proceed with this reform without further delay.[10]

3.6 The second counterfactual is based on an improbable account of possible future developments in the industry. The NZIER report acknowledges that the removal of

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7 L Evans and N Quigley, 'Dairy farmers face tough choices', *National Business Review*, July 30, 1999, p 43.

8 This is conceptually distinct from the situation where price premiums arise from a country-specific import quota.

9 NZIER, *Dairy Industry Restructuring: Application for Authorisation*, report to Chapman Tripp, June, 1999.

10 The methodology of the study on which NZIER has based this estimate is highly conservative and does not take account of many of the potential benefits, noted earlier, that are likely to flow from the removal of the single desk arrangement.

statutory single desk exporting is likely to occur at some time in the future, even in the absence of authorisation of the proposed merger. It suggests, however, that in this situation NZDG and Kiwi are likely to develop competing export marketing businesses that would incur diseconomies by duplicating marketing arrangements. While this outcome is not impossible, it would be unlikely to eventuate because alternative strategies are likely to be more attractive to both NZDG and Kiwi.

3.7 Neither NZDG nor Kiwi would have any incentive to withdraw from a joint marketing venture (the successor of the Dairy Board) unless they saw prospects of being able to obtain higher returns from an alternative strategy. This could occur if inefficiencies associated with management of the joint venture exceed the benefits of scale and scope obtained from it. However, if such economies are as significant as claimed, the joint venture partners would have a strong incentive to overcome the management problems likely to be involved. The fact that joint ventures are a fairly common form of business organisation suggests that the problems of ensuring efficient management of such businesses are not necessarily insuperable.

3.8 Another reason why either NZDG or Kiwi may wish to withdraw from a joint marketing venture is because of the potential to obtain greater benefits by forming some kind of partnership or alliance with a foreign marketing company. It is possible that within a few years both NZDG and Kiwi will see more benefit in becoming involved in alliances with foreign firms than in joint ventures with each other. This could enable the New Zealand industry to benefit from the access to additional markets and marketing expertise that these international linkages would make possible. If this occurs, the benefits to the industry (and for New Zealand) from becoming involved in international alliances will exceed any losses from scale economies associated with the discontinuation of the joint venture.

3.9 Another possible scenario is some combination of a joint venture arrangement for the export marketing of some products and the direct involvement of one or both venture partners in separate alliances with foreign firms for the marketing of other products. Nothing can be said with certainty about the way the corporate structure of the dairy industry might evolve in a contestable environment. We do know, however, that contestability provides incentives for firms to find low-cost methods of production.

3.10 The proponents of Mega-coop claim that the benefits that will accompany it include:

- the elimination of the bundling of dividends on off-farm investment in processing and marketing in the returns farmers obtain for milk; and

- improved access to capital for investment in the processing and marketing of New Zealand milk.

Neither of these benefits is unique to the Mega-coop proposal. Indeed, there is no guarantee that unbundling will occur in an appropriate way under this proposal and the establishment of Mega-coop seems more likely to deter external investment in the industry than to encourage it. The proposed restrictions on the transfer of shares seem designed to discourage investment in Mega-coop from outside the dairy industry. In addition, as discussed below, the potential for Mega-coop to discourage farmers from supplying competitors may tend to impede investment in competing processing and marketing ventures.

3.11 Even if there were good reasons to expect the creation of Mega-coop to generate substantial benefits for the industry, it would be extremely risky to gamble all the equity that has been built up from past investments in processing and marketing on the strategies to be adopted by one firm. The risks of having all eggs in one basket have been evident in recent years, for example in the performance of the foreign exchange hedging strategies adopted by the Dairy Board and in the dispute with the UK Customs over duty arrangements.

## 4.0 Possible economic costs of Mega-coop

4.1 Under normal commercial conditions, if firms in an industry were to decide to merge their export activities there would be good reason to expect that this would be in New Zealand's overall interests. The firms concerned could generally be presumed to have come to the judgment that the merger would result in a net increase in returns from their combined export activities. A merger relating exclusively to export activities would not be likely to have an adverse effect on domestic consumers unless the companies concerned were big players in the domestic market. There would generally be no other reason to expect that the potential costs to the New Zealand economy of such mergers would exceed the benefits involved.

4.2 However, the proposed formation of Mega-coop differs in important respects from a merger of export activities taking place under normal commercial conditions. It involves firms that are big players in the domestic market and the firms involved in the merger are cooperatives.

*Domestic market implications*

4.3 In order to prevent Mega-coop having a monopoly of town milk supplies, the proposal provides for divestment by the merged entity of a company with the capacity to provide approximately 40 percent of current town milk supply. Divest Co would also be a substantial supplier of butter, yoghurt and cheese. It is also proposed that, for a period of five years, Divest Co would be provided by Mega-coop with secure and transparent contracts for the supply of milk and dairy products.

4.4 The extent to which the proposed supply contract would safeguard the interests of consumers would depend on the terms of that contract. However, the longer-term future of competition in the domestic market would be likely to depend more importantly on the ability of Mega-coop to impede efforts by Divest Co to develop its own supplier base by attracting suppliers away from Mega-coop. The main way in which Mega-coop is likely to be able to impede competitors in obtaining access to supplies is via restrictions on transferability of its shares. This issue is discussed below.

*Implications of the cooperative structure*

4.5 There are several reasons why standard approaches to analysis of the potential of a firm to exercise market power may need to be modified for the analysis of mergers between cooperatives. The most obvious reason is because cooperatives are less likely to be able to restrict supplies in order to obtain monopoly profits at the expense of consumers. While this is a good point, it tends to undermine the industry's argument that in the past it has been able to exercise market power internationally under the single desk seller arrangement. In fact, if Mega-coop continues to bundle some returns from marketing and processing activities in prices paid to farmers, there is reason to believe that the volume of supplies going on to the market will exceed the amounts that would be supplied by investor-owned firms in a competitive market situation. If some degree of bundling is retained, farmers will still base their production on distorted prices that do not reflect the economic value of the raw material they produce.

4.6 It has also been suggested that standard approaches may not be valid because the ownership of cooperatives by suppliers removes the incentive for the merged firm to exercise market power at their expense. Participants in the proposed merger have argued to the Commerce Commission that "the ability of the owners of the cooperative to exercise market power to the detriment of suppliers is absent". The participants in the proposed merger acknowledge that shareholders and management views on the operation of the cooperative may differ. They suggest, however, that farmers have "proven themselves to be well-informed on issues facing their co-operative, and prepared to expend the energy necessary to ensure their view is taken into account".[11]

4.7 Despite the obvious fact that Mega-coop would be farmer-owned, it is still quite plausible that it could use a dominant position in the market for acquisition of raw milk to exercise market power at the expense of its supplier members.[12] The argument that this could not happen is almost as naive as the old socialist view that state-owned enterprises could not use their dominant position in markets to exercise market power at the expense of the general public which owned them. It ignores the potential for managers and employees of these businesses – the agents of the shareholders – to pursue their own interests, for example in empire building, rather than achieving higher returns for shareholders.[13] Such principal-agent problems are of particular concern wherever restrictions on competition interfere with the usual market tests of profitability and hence make it difficult for board members and shareholders to monitor the financial performance of their agents.

4.8 A report commissioned by the NZBR has noted that the ownership of a firm by suppliers of raw materials also tends to raise agency costs relative to the situation under investor ownership:

> The costs to owners of monitoring the performance of managers (and agency costs associated with managerial opportunism and slack performance) may be increased because managers are likely to have unclear and ambiguous objectives. Rather than being required to maximise shareholder value, as in the case of investor-owned firms, they are likely to be required to balance the interests of owners as investors and as suppliers of raw materials. Under these circumstances managers are likely to have plenty of excuses for poor performance.[14]

The claim that farmer-shareholders of dairy cooperatives have been able to prevent productive inefficiency in these organisations and the Dairy Board in the past through their exercise of voice is not supported by the results of recent research by the Treasury and NZBR. This research suggests that, after making appropriate adjustments to ensure comparability, prices received by New Zealand farmers for

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11 Notice seeking authorisation of the proposed merger under section 67 of the Commerce Act 1986, submitted to the Commerce Commission by G Calvert on behalf of the company to be formed, June, 1999, paragraphs 14.24–14.31.

12 The question at issue here is not whether cooperatives are ever capable of serving the interests of farmers. There are some circumstances in which supplier-owned cooperatives may be of benefit to members. This has been evident in the ability of some cooperatives in other countries to survive in open competition with other forms of business organisation. The question is whether the mere fact of ownership by farmers provides sufficient reason to assume that cooperatives will not exercise power at the expense of their members.

13 Some of the economic issues involved in use of market power to obtain non-pecuniary benefits – such as additional status, more job security, or a quieter life – are essentially the same as those involved in use of market power to earn monopoly profits. However, organisations in which such non-pecuniary benefits are unusually prevalent are often characterised by poor incentive alignment and hence a great deal of productive inefficiency, as well as the potential for the exercise of market power.

14 W Bates, *Farmer Control of Processing and Marketing*, New Zealand Business Roundtable, August, 1998, p 30.

milk over the period 1993/94 to 1996/97 were 10 to 20 percent below the returns obtained by Australian farmers.[15]

4.9 While there is probably some validity in claims that supplier shareholders in small cooperatives are able to monitor these firms effectively and hold management accountable, the amalgamation of cooperatives and the extension of their activities into further value adding has made monitoring more difficult. This has previously been recognised by commentators within the dairy industry. For example, in 1997 Murray Gough, a former chief executive of the New Zealand Dairy Board, has argued:

> With 2 companies now handling 75 percent of NZ's milk, and further rationalisation probable, it is becoming difficult, if not impossible, for suppliers to measure company efficiency ... . Whereas dairy company competition was a vital driver for efficiency in the past, there will be much less benefit to be gained by suppliers from this in the future.[16]

While it is likely that some farmers will be vocal participants in the affairs of the Mega-coop, there may be a tendency for industry politics to focus on the different interests of suppliers in different regions at the expense of strategic considerations affecting overall returns to members. It is clear that north and south island farmers have different interests in relation to a variety of issues.[17]

4.10 There are several additional reasons why the dominant position of Mega-coop could be expected to be detrimental to its supplier members:

- The returns that farmers obtain from their investment in Mega-coop may remain obscure. It is only if returns to farmers from off-farm investment are separated from the price they receive for milk, and shares are made fully tradeable, that the rate of return on these investments will be readily apparent. There have been some suggestions that the Mega-coop will discontinue the practice of bundling and that limited tradeability of shares will be introduced. However, there is nothing in the legislation that would require Mega-coop to abandon bundling and allow its shares to be freely traded.

- If ownership of shares in Mega-coop is restricted to farmer suppliers, there may be little incentive for fund managers and other financial market analysts to monitor its performance. Control of many public companies is exercised by a few major shareholders who have a strong incentive to monitor performance closely. When ownership is widely dispersed, monitoring by potential purchasers of shares (including those considering establishing a controlling interest) helps to ensure that firms are managed in the interests of existing shareholders. This discipline will not apply in the case of Mega-coop if external investors are precluded from ownership of shares.

- Landowners who wish to sell their shares in Mega-coop and sell their milk to an alternative processor will not receive the full commercial value for their shares if tradeability is restricted. The restriction of share ownership to owner suppliers is likely to depress the price of shares substantially. A much less severe restriction on share ownership – the requirement that Air New Zealand 'A' shares can only be owned by New Zealanders – has resulted in the price of that class of shares trading below the freely tradeable 'B' shares by a margin of

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15 G Sinclair, *Costs and Benefits of Producer Board Deregulation*, Treasury Working Paper, 99/4, p14; and Bates, 1998, *op cit*, pp 20–22.

16 M Gough, 'Structural Change: An Evolutionary Path', *Dairy Exporter*, August, 1997, pp 97–98.

17 Issues that may be divisive include the possibility of varying prices paid to suppliers among locations depending on transport costs, and the location of manufacturing plant.

more than 20 percent. The depression of the price of Mega-coop shares below their value in an open market may act as an inducement to landowners to continue to supply Mega-coop rather than to sell their shares and supply a competitor.

- Since shares in the Dairy Board are not tradeable it is not obvious that cooperatives that do not wish to participate in Mega-coop will receive the full commercial value of their shares. Even with the best will in the world it is difficult to assess the value of shares in the absence of an open market in those shares. For example, the values placed on shares in state-owned enterprises prior to privatisation have frequently been substantially lower than the values subsequently placed on them in an unrestricted market. Even with the value of shares being determined by independent experts, there is a possibility that the compensation offered for relinquished shares will tend to discourage exit and thus tie smaller cooperatives and their suppliers to Mega-coop

- Farmers will have no choices of alternative outlets for their milk (other than in the few cases where small cooperatives elect not to join Mega-coop and geographical transfers are possible), at least until a new entrant manages to obtain a foothold in the industry. In addition, they will have no basis for comparing the performance of Mega-coop with other comparable firms, an important form of supplier and investor protection in many industries. As has been the case with the Dairy Board, commercial mistakes made by Mega-coop could go undetected for years.

4.11 If Mega-coop is able to use its dominant position to discourage landowners from supplying potential competitors, this is likely to have detrimental effects on the growth of the dairy and related industries in New Zealand. While such tactics would impede Mega-coop's competitors, they would be unlikely to prevent the emergence of competition because sharemilkers, and farmers who do not have equity in Mega-coop, would presumably be willing to supply milk to potential competitors if attractive contracts were offered. In the longer term, there is a strong probability that the weight of its own inefficiency would become so great that Mega-coop would no longer be able to impede the growth of competitors. In view of the importance of the dairy industry to the New Zealand economy, however, it would be highly undesirable to set the structure of this industry on a course that is likely to continue to impede economic growth for any additional time.

**5.0 Arrangements for quota markets**

5.1 The purpose of these provisions of the Bill is to maximise the economic benefits for New Zealand from restrictions maintained by foreign governments on access to their domestic markets. The proposed arrangements will certainly be more efficient than the Dairy Board's statutory export monopoly as a mechanism to achieve this objective.[18]

5.2 A case could be made on equity grounds that quota rents accruing to New Zealand as a result of country-specific import quota should belong to the community generally because they represent a return on public investment in international negotiations. However, these rents have in the past been allowed to flow to dairy farmers and it is unlikely that there will be any efficiency gains from changing this distribution of benefits.

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18 The proposal that export licences in respect of designated quota markets be allocated automatically to Mega-coop for an extended period will need to be taken into account in determining the value of shares in the Dairy Board. The capitalised value of quota rents to be obtained by Mega-coop should be included in this valuation.

5.3 In brief, the proposed arrangements for the allocation of export licences to designated quota markets are as follows:

- the existing allocation will remain in place for at least six years;
- competition for licences to export to these markets will be phased in gradually over the following four years;
- the allocation of licences will be administered by a company which will aim to maximise their sustainable value for the benefit of its shareholders;
- shares in this company will be issued to farmers in proportion to milk supplied and will be tradeable (under conditions to be approved by the minister).

5.4 A case can be made that the competitive allocation of licences to designated quota markets that is proposed to occur eventually may be less efficient than the 'permanent' allocation of licences to one or more firms.[19] It could be argued that permanent allocation would provide the firms that are allocated licences with stronger incentives to invest in brand development in respect of these markets. It would do this by removing the possibility that a licence may be auctioned off to a different firm after a few years. The permanent allocation of licences would also avoid the costs involved in setting up a company to allocate quota and to distribute rents to farmers.

5.5 Against this, it is likely that inefficiencies would arise from the permanent allocation of licences to quota markets to Mega-coop, which is the only obvious candidate under the proposals contained in the Bill. If licences were to be allocated permanently to Mega-coop, there is no guarantee that the benefits of quota rents would flow through to farmers. They could well be used to protect Mega-coop from competition from other firms seeking access to New Zealand milk.

5.6 The NZBR considers, on balance, that the proposal for licences to be allocated competitively is preferable. Since the company responsible for quota allocation will have a strong incentive to maximise their sustainable value it can be expected to determine the tenure of licences with a view to ensuring that holders have appropriate incentives to invest in brand development.

5.7 However, the Bill's provision of a protracted transitional period, before competition for licences begins, is completely unwarranted. No industry adjustment issues arise in this situation (unlike, for example, in the case of tariff reductions). The effect of this delay can only be to give Mega-coop additional potential to subsidise itself at the expense of dairy farmers. Farmers should not have to wait a further six years before they begin to receive directly the proceeds from quota rents.

5.8 Another area of concern is the proposal to apply the formal licence arrangements to all markets in which country-specific quotas apply, even though quota rents are likely to be significant only in the European Union (EU) butter market (and a few other markets.) Given the existence of administrative machinery for licence allocation, the marginal costs of using it in respect of an additional market may not be large. Nevertheless, use of this machinery may still be an unduly cumbersome way to deal with an issue that could easily be resolved by voluntary cooperation among exporters.

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19 The 'permanent' licences would, of course, be no more permanent than the period for which New Zealand exports remain limited in each designated market by a country-specific import quota.

5.9 Finally, the Bill is not sufficiently explicit about the conditions under which shares in the proposed licence allocation company are to be tradeable. It is difficult to imagine how farmers, or anyone else, could benefit from a restriction on who may own those shares. The shares will not provide owners with any influence over the production, processing or marketing of dairy products. There is no reason why farmers who wish to sell these shares should not be entitled to sell them to obtain the maximum returns possible. That means that farmers should be permitted to sell these shares to anyone who may be interested in holding a financial asset of this type.

NEW ZEALAND BUSINESS ROUNDTABLE

# COMMENT ON LABOUR'S DISCUSSION PAPER

## *IMPROVING CONFIDENCE IN THE SHAREMARKET: TOWARDS A BETTER COMPLIANCE REGIME*

JULY 1999

## 1.0 Introduction

1.1 This comment on the Labour Party's discussion paper (the Paper), *Improving Confidence in the Sharemarket: Towards a Better Compliance Regime* 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 national interests.

1.2 The Paper favours greater regulation of takeovers and insider trading and greater coordination, if not amalgamations, of regulatory institutions and regimes. It asks for comments on these proposals and provides 11 specific questions to guide respondents.

1.3 The NZBR agrees with the Paper about the importance of investor confidence in the integrity of New Zealand's markets. It is critical for national prosperity, let alone the efficiency of markets, that laws against fraud and coercion are enforced, property rights and the sanctity of contract are protected, and the rule of law prevails.

1.4 We agree with the Paper that any issue of gaps in the law that might permit fraud, theft or coercion to flourish deserves serious consideration. Securities market regulation is a widespread phenomenon, although the details differ widely across countries. We should all keep an open mind about what New Zealand can learn from the experience of others. There is an extensive academic literature that offers theoretical and empirical guidance on sound policies.

1.5 We are encouraged that Labour has been prepared to disclose its thinking on such important policy issues in this way and to invite informed public comment and debate. We are pleased to participate in the same spirit and hope that Labour will take the same approach in relation to other major policy issues.

1.6 Section 2 sets out our framework for addressing the issues raised in the Paper. Section 3 applies this framework to the overall problems identified in the Paper and the objectives it sets for public policy. Sections 4 and 5 apply it to issues that are specific to takeovers and insider trading respectively. Section 6 comments briefly on the structure for regulatory agencies. Section 7 presents some concluding observations.

## 2.0 Questions to consider in assessing regulatory proposals

2.1 In recent years, many countries have given serious consideration to the problem of how to improve the quality of their regulations. New Zealand shares in the common problem of too much regulation of dubious quality. The New Zealand Statute Book is reported to have comprised more than 60 volumes at an average of 800 pages in each volume back in 1978. On one estimate, 1,600 new pieces of legislation and 3,600 new regulations have been added in the last decade. In 1990 the New Zealand Law Commission estimated that around 4,000 new pages are added to the volumes of legislation each year. In stark contrast, Hong Kong is reported to have fewer than 1,000 regulations in total affecting business.

2.2 Parliament's ability to make law far outstrips the ability of individuals to absorb its implications. An employment relations consultant has listed 10 Acts that have significant implications for employers and another 12 that are relevant. No small employer could hope to make time to understand all the ramifications. Few could afford much expert help. But this burden is surely minuscule when compared with the tax laws and intrusive and burgeoning safety and environmental regulation. Flying blind must be the order of the day for many New Zealand businesses. The largest spend millions of dollars a year, simply to minimise the risk of inadvertent breaches.

2.3 The general public must also, of necessity, be deeply ignorant of the implications of much of this legislation if rigorously enforced. Nor can there be much doubt that were it to be rigorously enforced, glaring inconsistencies, absurdities and inequities would result. No systematic process exists for weeding out outmoded, irrelevant or ineffectual regulations.

2.4 Inadequate laws, uncertainty about their application, corrupt or ineffectual enforcement, excessive delays and costs in obtaining legal remedies and unpredictable law making, either by parliament or the judiciary, all make a country less prosperous. It is highly desirable for commerce that law-abiding people know, at low cost, the difference between legal and illegal actions. Otherwise, reputable businesses will be deterred from participating in markets. 'Safe harbours' are highly desirable for this reason. Laws of uncertain application frustrate all affected parties, raise costs and reduce activity.

2.5 The Organisation for Economic Cooperation and Development (OECD) has produced many reports on the problem of improving the quality of regulation and the experiences of countries that have systematically attempted to ensure that regulations are more soundly based. As a result, it has proposed the following 10 questions for evaluating regulatory proposals:[1]

(i) is the problem properly defined;

(ii) is government action justified;

(iii) is regulation the best form of government action;

(iv) is there a legal basis for regulation;

(v) what is the appropriate level of government for this action;

(vi) do the benefits justify the costs;

(vii) is the distribution of effects across society transparent;

(viii) is the regulation clear, consistent, comprehensible and accessible to users;

(ix) have all interested parties had the opportunity to present their views; and

(x) how will compliance be achieved?

2.6 In New Zealand, Cabinet Office Circular CO (98) 5 requires Regulatory Impact Statements to accompany regulatory proposals taken to cabinet.[2] These statements require, *inter alia*:

- the problem to be clearly identified, taking care to focus on root causes rather than symptoms;

- the public policy objective to be specified, but not so as to align with (and thereby pre-justify) the particular effects of the proposed regulation. Rather it should be specified in relation to the underlying problem;

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1 See p 208 in *Report on Regulatory Reform: Volume II: Thematic Studies*, Organisation for Economic Cooperation and Development, 1997.

2 Cabinet Office Circular CO (98) 5.

- feasible regulatory and non-regulatory options must be identified that could wholly or partly achieve the specified objectives; and

- all regulatory costs must be identified and the excess of benefits over costs demonstrated – as distinct from asserted – against all feasible alternatives.

2.7 We use the framework provided by CO (98) 5 to discuss the Paper's proposals in relation to takeovers and insider trading.

## 3.0 Application to the Paper's overall perspective

### Problem definition

3.1 The Paper motivates its proposals by expressing concern about:

- the low numbers of private investors in New Zealand relative to Australia;

- a poor sharemarket performance compared with Australia and some other countries since the 1987 sharemarket crash; and

- a relatively low number of registered companies listed on the New Zealand Stock Exchange compared with the pre-October 1987 situation.

3.2 None of these concerns raises any issues specific to takeover or insider trading situations. The Paper simply presumes, first, that more regulation of takeovers and insider trading would materially raise the proportion of shares held directly by private investors, improve our relative sharemarket performance and increase the number of companies listed on our market; and, second, that all of this would be a good thing. The following subsections explore these twin presumptions.

***Low numbers of small shareholders relative to Australia***

3.3 The Paper gives no data establishing that such a gap exists. Nor does it identify how large is the alleged gap or whether it has changed. Even if a gap did exist, which is by no means established, it is not clear why a lower number of small shareholders than in Australia should be regarded with concern.

3.4 The suggestion by those promoting more regulation that low shareholdings by one group of investors (small shareholders) are a sign of too low a level of confidence implies, by the same logic, that the inevitably high share of at least one other group is a sign of too high a level of confidence. It is impossible for every group to have a high share. It is hard to make sense of such a self-contradictory proposition.

3.5 Another puzzle arises from the comparison with Australia. Why would we expect the proportions to be the same between the two countries? Have they ever been the same? Small shareholders can get their sharemarket exposures directly or indirectly through superannuation funds, listed or unlisted unit trusts and mutual funds, life insurance products and investment companies. Since diversification is sensible, it is sensible for many to avoid direct investment.

3.6 The same principle makes it rational for New Zealanders to own a smaller proportion of the New Zealand market that it would be for Australians to own of the Australian market. New Zealand's sharemarket is only 0.1–0.2 percent of the world market. Foreign exchange controls stopped New Zealanders from diversifying optimally until 1985. Nor were global investment vehicles as readily available then as they are today and will be tomorrow. New Zealanders are becoming more global in their investing and they are making greater use of pooled investment vehicles such as unit trusts. Only those who fail to understand the benefits of diversification could find this disturbing. We should not be surprised to see, in due course, many New Zealanders having more than 90 percent of their sharemarket investments offshore.

3.7 Another feature of the New Zealand market that may be associated with size is the much greater significance of block shareholdings in this country. Often they take the form of a major overseas shareholder. Major shareholders can provide access to markets, finance, know-how, technology and employment opportunities that New Zealand companies often could not provide as well, if at all. The implication is that fewer shares are available for local investors. But as just noted, local investors could be happy to diversify globally.

3.8 One possible answer to the puzzle of using Australia as the point of comparison is that those proposing greater regulation of the New Zealand market could want us to assume that Australia's sharemarket is more attractive to small shareholders because of Australia's takeover code. Indeed, that code does have a mandatory bid and equal price rule that the advocates of regulation defend on the grounds that such a rule 'protects' smaller shareholders. But good intentions do not necessarily lead to good regulations. Small shareholders do not benefit if a takeover code deters bids and thereby prolongs the existence of under-performing boards and management teams. Regulations have a cost. Small shareholders have a sharper incentive to worry about these costs than do those proposing more regulation.

3.9 What do we know about small shareholder preferences on this point? The first point is that if legislatures do not deprive small shareholders of the ability to choose, they overwhelmingly fail to demonstrate that they see an equal price rule as being in their interests. A century of revealed preferences demonstrates this in a passive way in New Zealand. When companies list on the sharemarket for the first time their pre-existing owners have to decide what rules in their articles of association will maximise the sum of the value of their ongoing shares in the company and the amount they will receive by selling shares to new investors as part of the listing process. Rules that disadvantage the new retail investors will depress the price at which these investors subscribe. The lower price compensates those who invest for those rules. It also means that the pre-existing owners cannot themselves benefit from rules that impose costs on small shareholders. There is no free lunch for anybody. Nor is anyone compelled to buy shares or accept arrangements at other than a satisfactory price.

3.10 New Zealand's experience in the past one hundred years is no different from that of other countries in this respect. Small shareholders faced with choice have not generally preferred equal price rules. New Zealand recently tested this proposition explicitly when the New Zealand Stock Exchange obliged shareholders in each company to choose between three takeover rules. This process demonstrated beyond any doubt that small shareholders overwhelmingly do not feel strongly about the matter, *even after the company has listed*.[3] In company after company they voted to support the option that their boards put in front of them. The few exceptions only served to prove the rule. In some of these exceptions the vocal shareholders were those most in favour of regulations that would deprive small shareholders of the ability to choose for themselves. The claim in the Paper that "the reality is that very few companies have opted for this due to voting procedures" is simply wrong.

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3 This is the more remarkable in that once shares have been bought at a price that would compensate small shareholders for the absence of an equal price 'protection', the imposition of a mandatory equal price rule should give small shareholders a free lunch. The passivity of the majority of small shareholders, even in the face of the emotion whipped up by the media, regulators and a handful of vocal, high profile, media-friendly 'shareholder activists', is entirely consistent with the view that they see no net benefits in such a rule even if they have to pay nothing for it.

Shareholder meeting after meeting saw the small shareholder category voting the same way as the large shareholder category. Again any exceptions were exactly that.

3.11 Putting the issue of shareholder preferences as revealed by history and voting to one side, data on small shareholdings could be examined to test the Paper's proposition that differences in the proportions of a sharemarket owned by small shareholders could be explained by differences in takeover codes. Were small shareholdings lower or higher before Australia adopted its code? How does Australia's proportion compare with those in other countries that do not have an equal price rule? The United States, for example, has no such rule at the federal level. Why not bring Asian and other countries into the comparison too? Have New Zealanders tended to invest more heavily in Australia than in the United States since Australia adopted its equal price rule? The proponents of an equal price rule have failed to consider any explanations for what they observe, other than the one that suits them.

***Poor sharemarket performance***

3.12 The implicit notion here is that poor quality regulations will produce a poor sharemarket performance. Those advocating greater regulation provide no rationale for such a relationship. This is a problem because standard finance theory would, if anything, postulate the opposite relationship. One of the most fundamental propositions in finance is that investors require a higher return where the risk is greater. Therefore, if a poorly regulated market is a source of risk for investors, poorly regulated sharemarkets should produce the highest returns, on average, other things being equal.[4] Those who favour regulation and attribute relative sharemarket movements to differences in regulations, ignoring all other factors, should conclude, if they understood basic finance, that New Zealand has the best arrangements. Of course their revised conclusion would be wrong because the influence of other factors cannot be ignored. Since those proposing greater regulation are happy to ignore the role of other factors when it suits them to do so, they would have to reject the revised conclusion on more expedient grounds.

3.13 No serious analysis could ignore the role of other factors. The pro-regulatory argument ignores entirely the fact that surprises are crucial to understanding observed returns. Again, it is scarcely believable that anyone with a sound grounding in efficient market theory and the propositions about the random nature of share price movements could overlook the possibility that disappointing movements in share prices are due to adverse news about likely future earnings. Investors buy shares in the expectation of satisfactory future earnings growth in relation to the price paid. Bad news about the prospects for future earnings growth will cause share prices to fall. When the fall in earnings is economy-wide, most share prices will fall, perhaps markedly. Typically, therefore, a market as a whole will fall because there is economy-wide disappointing news.

3.14 The proponents of regulation after the 1987 sharemarket crash failed to consider the possibility that company earnings had fallen dramatically and that a large number of companies were insolvent for this reason. To the contrary, the Russell Committee inquiry into the sharemarket famously declared that it was essential to implement its regulatory proposals in order to restore confidence in the sharemarket. It provided no evidence at the time that share prices were unduly low in relation to earnings. Certainly they were not too low with the benefit of hindsight. How regulations could restore property prices and economic growth was left to the imagination. In

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4 Investors who are concerned about risk and return will invest in a poorly regulated market when prices are low enough and future dividends look promising enough to satisfy their requirements for expected return in relation to risk. Obviously they will only invest in a well-regulated market on the same basis. If a less well-regulated market is more risky, they will only buy into it if the expected return is higher than in a well-regulated market.

time, the Committee's prediction was falsified by the subsequent economic and market upturn – without the benefit of its proposed regulations. The British scheme of regulation which the Committee proposed has subsequently been abandoned in Britain, suggesting New Zealand was wise to reject it. Regrettably, history reveals a tendency for regulation to follow from major sharemarket crashes.[5] The opportunism of those making such self-justifying claims for their regulatory proposals is rational.

3.15 The powerful relationship between national economic performance and exceptional sharemarket performance is a matter of everyday observation. In the 1990s the United States economy has been extraordinarily strong, along with its sharemarket. Japan just as dramatically demonstrates the opposite combination. The recent Asian crisis saw Asian sharemarkets and economic growth turn down. Since the mid-1990s Australia has been out-performing New Zealand in terms of economic growth and sharemarket performance. In turn New Zealand has been out-performing the worst-performing Asian countries on both counts.

3.16 Turning to hard data, Chart 1 in the Appendix shows the close relationship between New Zealand's relative sharemarket performance and its relative economic growth. The relationship between shocks to economy-wide performance and shocks to sharemarkets is so obvious that it is almost impossible to conceive of any respectable reason why the proponents of securities regulation would overlook it.

3.17 Chart 2 in the Appendix demonstrates another obvious and related point, namely that New Zealand's market has both out-performed and under-performed world markets since the 1987 crash. This is what efficient market theory would lead all who have studied it to expect. The regulators assume that poorly regulated markets will under-perform consistently until better regulations are imposed. This amounts to saying that investors are stupid – they are happy to stay in the market at prices at which they repeatedly lose money. In fact numerous academic research articles support the now-uncontroversial proposition that movements in share prices are highly random. Persistently negative returns would be highly non-random.

3.18 Of course, in any period any given sharemarket may have under-performed or out-performed the world, or at least a few markets. Those favouring regulations may pick a historically high market peak to start the period and a low point to end it. This argument of convenience works best when the low point is the current period. In this case, the pro-regulation argument is that whatever upturns occurred in between these two points were more than offset by the falls in other sub-periods. "Of course, we know that markets are volatile", they might say, "but the overall negative return is what counts, and it cannot be denied". What this argument attempts to avoid is the dual response that (1) if the overall return is what counts, the regulators' own logic requires them to extend the start period back to the beginning of the market and (2) market swings can only be explained by surprises. Only a surprise change in regulation might be able to explain an observed change in share prices. There has been no surprise movement to less securities market regulation in New Zealand that could explain New Zealand's sharemarket performance since the October 1987 sharemarket crash. To the contrary there has been increasing regulation of surveillance, disclosure and liability through changes to the Companies Act 1993, the Stock Exchange's listing requirements and new legislation. If disappointing sharemarket returns are due to bad regulations, as those promoting regulations would have us believe, the advocates of further regulation have to put their telescopes to their blind eye in order to draw their preferred conclusion.

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5 It is human nature to succumb to greed during booms and to seek to blame others for losses when the crash occurs. Accusations of foul play strike a responsive chord at such times.

*The drop in company registrations*

3.19 New Zealand experienced a major sharemarket boom prior to the October 1987 sharemarket crash. Investor confidence was extraordinarily high – in the absence of the regulation desired by the Securities Commission and in the presence of the Labour government's moves to free up the economy and rein in inflation and fiscal deficits. A large number of property and investment companies were floated during the boom. Most were too highly geared to survive the crash. The argument that New Zealand needs further regulation because our market is still no longer as swollen by property and investment companies as it was in 1987 can only prompt the question as to why the pre-crash situation should be regarded as the norm. Again it is hard to conclude that the choice of the period of comparison is other than self-serving.

3.20 To conclude, the requirement in CO (98) 5 that the case for regulation be based on root causes rather than symptoms is surely unexceptional. The regulators' arguments discussed above fail totally in this respect. Indeed, it is hard to even make a case that the first and last are symptoms of a problem.

3.21 The rationale for focusing on Australia when assessing regulations is truly puzzling. Why would New Zealand only compare itself with Australia? Australia's economic performance, while better than New Zealand's, is clearly mediocre. Only a defeatist about New Zealand's future would settle for the proposition that what Australia does provides the right model for New Zealand.

3.22 The inescapable conclusion is that the proponents of further takeover and insider trading regulation have given up on the task of putting forward any analytical case for the measures they propose. Instead they rely on *ad hoc* arguments based on implicit propositions that are contradicted by basic finance theories, and on a casual empiricism that ignores all relevant factors except the most convenient one for their case. The phenomena just discussed are easily explicable by far more powerful, and unrelated, factors.

3.23 The dog that did not bark, by its silence, provided Sherlock Holmes with crucial information in one of Arthur Conan Doyle's novels. In the Paper, the telling clue is the absence of any reference up to this point to any problems that specifically relate to insider trading or to takeovers.

*The public policy objective*

3.24 The Paper appears to have two distinct public policy objectives. Its title and much of its discussion suggests that a key concern is that New Zealand's "extremely light-handed" regulation may hinder our sharemarket performance. However, it also states on page 3 that Labour's "fundamental concern is the need to promote confidence in the [share]market". This is not the same as improving sharemarket performance.

3.25 A move to better or lower quality regulation of the sharemarket could surely raise or lower market prices as a one-off effect. This effect is worth having. That is why good rather than bad regulations are desirable, even if companies are unlisted and we cannot observe the effect. The objective of improving confidence is consistent with a desire to achieve a one-off effect on share prices.

3.26 However, only changes that have an enduring effect on the *growth* of company earnings per share can be expected to have an enduring effect on sharemarket performance. The Paper offers no mechanism by which a change in takeover or insider trading laws could be expected to change the *growth* in company earnings. Conceivably some relationship could be postulated, however tenuous and hypothetical, although it is not obvious what form it would take. Most obviously, it would work in the opposite direction since laws making takeovers more costly shelter boards of directors and managements that are failing to perform. However, even this proposition is tenuous, for the reasons discussed earlier.

3.27 The fundamental factor driving sharemarket performance must be expectations about future company earnings. This is what rational investors attempt to price. Fundamental determinants of future company earnings include the economy-wide rate of economic growth and the rate of growth in business productivity. They do not include securities regulation.

3.28 For these reasons, we focus in the remainder of this comment on the alternative objective of finding regulations that promise to give a one-off benefit to share prices in the form of a one-off but sustained lift in investor confidence.

3.29 The objective of lifting investor confidence is a strange one to use to drive discussions about securities regulation. Other factors may have a much greater bearing on investor confidence. For example, investor confidence can be expected to be affected by:

- worries about New Zealand's future growth prospects and policy drift;
- fears of a downgrade in New Zealand's credit rating;
- concerns about political stability in a Mixed Member Proportional (MMP) electoral environment;
- uncertainty about future taxes affecting capital gains and high income earners;
- concerns about draconian penalties (eg earnings-related penalties) in proposed amendments to the Commerce Act 1993 when it is unclear what behaviour does or does not constitute a violation of that Act;
- concerns about the willingness of governments to expropriate shareholder wealth (through regulatory takings), as in the case of the forced separation of line and energy companies with no proof of wrong-doing;
- concerns about government regulations, such as environmental, health, safety and competition regulations, that undermine certainty about property rights and impose costs, yet have not been justified by any respectable cost-benefit test;
- a local environment that is sometimes seen to be anti-Asian, anti-immigration and anti-wealth; and
- central and local government opportunism at the expense of businesses, as is evidenced by the drive to recover from businesses the costs of supplying public goods, and the unconscionable allocation of rating burdens on businesses based on spurious arguments about the concessional treatment of businesses for the purposes of income tax and goods and services tax (GST).

3.30 A much more conventional statement of the objective of securities regulation would be to promote economic efficiency. Setting this as the objective for the proposed measures should lead to a search for problems that are specific to the regulations under consideration.

*Identification of options*

3.31 The Paper fails to identify alternative courses of action that might affect sharemarket confidence. There is absolutely no reason to believe that the options it does consider are likely to have any material influence on confidence compared with other factors, such as those listed above.

3.32 The Paper's concerns about sharemarket performance should surely be addressed at the effect of policy on the level of earnings and economic growth rather than on sharemarket confidence.

*Net benefits*

3.33 Net benefits are derived from a comparison of alternative courses of action, not from a comparison between the status quo and the proposed course of action. Because the Paper fails to consider alternative ways of promoting confidence it cannot establish that there are any net benefits to what it proposes.

*Overall assessment*

3.34 The Paper fails to identify the root causes of any problems. The one clear problem that it does identify (poor relative sharemarket performance) has obvious potential causes that the Paper does not consider. The most obvious explanation for this problem is low earnings and low economic growth. We are at a loss to understand how regulators can think that securities regulation can make the sharemarket feel more confident about earnings that do not exist.

3.35 If the Paper's objective is to increase investor confidence, it would be useful to motivate this objective by establishing that there is a confidence problem. It does not do so. The most obvious indicator of confidence in the sharemarket – its price-earnings multiple – does not indicate any confidence problem from a historical perspective. Of course, if expected earnings growth were higher, multiples would be higher. Multiples are higher at present in some faster-growing economies. But securities regulation cannot make investors more confident about future company earnings. While governments can influence expectations about future economic growth and company earnings in many ways, the Paper ignores all the possibilities but regulation. It thereby fails to establish any net benefit for its proposals in terms of the given objective.

3.36 The bottom line is that the proposed securities regulations need to be evaluated purely on their merits in terms of what they are attempting to do (eg curb specific forms of wrong-doing). We assess the merits of a drug not on the basis of its contribution to our daily diet but on how well it treats specific ailments. We should evaluate securities regulation similarly.

## 4.0 Takeover regulation

4.1 Takeover regulation has been intensively debated in New Zealand since the Securities Commission initially proposed the regulation of takeovers in the early 1980s. New Zealand and overseas academics have made notable contributions to the debate from the perspectives of law, economics and finance.

4.2 The debate appears to have reduced to two issues:

- the proposition that a more intrusive code is necessary to control wrong-doing (so-called 'looting') of companies; and

- the argument that a mandatory bid and equal price rule is desirable to protect small shareholders.

4.3 Major changes to the Companies Act 1993 and the Stock Exchange's listing rules and the advent of the Stock Exchange's Market Surveillance Panel have yet to be shown to be so deficient in relation to wrong-doing as to warrant the addition of the proposed code. The Paper does not even mention this issue, so we say no more about it in this submission.

4.4 The Paper relies solely on the second argument. We have already commented on this argument in section 3. The argument is wrong about the reasons for shareholder choices. It is also totally dismissive of shareholder choice and shareholder democracy.

4.5 Professor John Pound of the Kennedy School of Government, Harvard University analysed this issue extensively for New Zealanders a decade ago. To the best of our knowledge, the proponents of such regulation in New Zealand have never provided rebuttals of his arguments in a form that could subject them to academic scrutiny in the conventional manner.

## 5.0 Insider trading legislation

5.1 New Zealand's insider trading laws are the result of shoddy, do-it-yourself economics and finance work by the Securities Commission that was rushed through parliament in the aftermath of the October 1987 sharemarket crash. The lead minister's rallying call was that it was necessary because the New Zealand sharemarket was the "last frontier of the Wild West". This was a totally inaccurate and irresponsible statement. That call and sympathetic post-crash public opinion sufficed to get the legislation past the objections of the more analytically minded.

5.2 The legislation failed to consider the problem as an issue of property rights in information. Typically, insider trading involves the wrongful use of company secrets. This is a matter between the owner of that information (typically the company) and the person who has abused the company's trust (typically an employee, manager, board member, senior shareholder or professional adviser). This issue might have been explored from the point of view of contract law and tort law. Issues of employment contracts, grounds for dismissal, recovery of losses from investments in information and reputation and the contractual relations between companies, advisers, boards and shareholders arise. Other remedies for breaches of contract could have been explored.

5.3 Instead, New Zealand followed the route taken in some overseas jurisdictions of treating it as an issue between a buying shareholder and a selling shareholder. This legislation was known to have proven to be at best troublesome in these overseas jurisdictions. There was no reason to expect that New Zealand's experience would be any better. Today, it is difficult to think of anyone who supports the legislation as it stands. The flaws at the heart of the current approach include:

- the absence of an obvious victim ( the shareholder unwittingly transacting with the insider is getting a better price at that moment than would have been available if the insider had stayed out of the market, thereby protecting the company's information;[6]

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6 Insider trading is sometimes referred to as a 'victimless crime'.

- its complete inability to penalise the insider who makes use of inside information by not transacting when they would otherwise have done so;[7]

- the uncertainty that is generated when legislators cannot define what is meant by such terms as "information given in confidence", "price sensitive", "likely to affect the market" and "tipping", and leave it to subsequent case law to define the boundary issues. Meanwhile, people who want to be law-abiding but who are dealing in financial markets do not know where they stand;

- its unavoidable insensitivity to the need for companies to use inside information with discretion. A rule forcing companies to publish to all or not tell (ie 'tip') at all denies companies an important property right in their own information;[8] and

- its intrusive effect on transactions that have been accepted for decades as acceptable business practice;[9]

- the adverse effect it has on certainty of contract because of the potential rewards it offers individuals to 'renege' on transactions and behave opportunistically;[10] and

- the opportunities it creates for competitors to use the regulations opportunistically for an anti-competitive purpose.[11]

5.4 New Zealand's legislation has clearly imposed significant costs on the community, particularly in respect of due diligence processes. It is hard to think of any clear benefit. Some might argue that the business community is much more aware now of the need to act with propriety. However, legislation may not change the climate of opinion about what is ethical behaviour. Instead, legislation that stands in the face of what is regarded as ethical behaviour (as in the due diligence case) could bring the law into disrepute.

5.5 When the insider trading legislation was introduced in 1988 two scenarios were possible. One was that it would be ineffectual because it was too difficult to enforce. The other was that its effects would be draconian if it were vigorously exploited and enforced. There is evidence of both effects.

5.6 In this paragraph we summarise our analysis of the proposals in the Paper using the framework in section 2:

- ***Problem identification*** No objective evidence is provided that concerns about insider trading are widespread. No particular incidents are cited. No distinction is made between informed assessments of the issue and populist beliefs or lay impressions. Instead a list of costs to private action is provided.

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7 This neatly illustrates the problem of focusing on transactions rather than on property rights information.

8 Normally, for example, companies would provide bankers, major shareholders and other important allies with sensitive facts in confidence that are important for monitoring and financial backing reasons but would be valuable to competitors. How much they said would depend on the situation and the level of trust. Legislation that ties the hands of the person who is thereby 'tipped' interferes with the company's ability to communicate.

9 The due diligence process and the Chinese walls in advisory firms provide two examples.

10 The transaction focus creates an incentive for a party to a transaction to pocket the proceeds with an insider if it goes well and 'renege' by threatening to bring an insider trading transaction if it goes badly. Major shareholders may no longer enjoy contractual security.

11 The 1995 book *Payback: The Conspiracy to Destroy Michael Milken and his Financial Revolution* by Professor Daniel Fischel of the University of Chicago economics department illustrates these issues.

- ***Policy objective*** The assertion is made that insider trading laws are crucial in promoting the market to small investors and in determining how overseas investors view the New Zealand market. However, ownership of the New Zealand market by small investors was probably far higher when New Zealand had no insider trading legislation (for unrelated reasons). Furthermore, the large portion of the New Zealand sharemarket now owned by overseas investors surely rebuts the claim that further regulation is crucial.

- ***Consideration of alternatives*** No consideration is given to alternative ways of promoting the market to investors – such as those relating to increasing New Zealand's economic growth prospects, or even to scrapping this ill-designed piece of legislation.

- ***Net benefits*** All the proposals seem likely to increase legal expenses and other costs. Some would increase the scope for opportunistic private actions by shifting the costs away from the opportunistic party on to innocent parties. Greater enforcement should deter both desirable and undesirable uses of price-sensitive information. The relative balance depends on how much undesirable insider trading there is in reality. We do not believe that it is high, but are open to evidence on this matter. On the other hand, there is a daily need for companies to be able to use price-sensitive information flexibly and sensitively and to be able to contract with confidence. These perspectives incline us to the view that the net benefits are strongly negative.

5.7 We favour a complete review of the entire legislation. In our view no amount of tinkering with it will prove satisfactory, but considerable damage is possible. The review should not be undertaken by the Securities Commission which is responsible for the present legislative mess. Until this review is undertaken the law may be best left as it is. New Zealand should try to avoid schemes that encourage excessive and opportunistic litigation. It will benefit lawyers, but this is not necessarily a national benefit.

5.8 The Paper also asks for comments as to who should fund the projected greater expenses of enforcement. In our view, public goods of a national interest nature are best funded from general taxation. As a rule, those who initiate private actions should bear the costs. Given the scope for opportunistic, anti-competitive and mischievous litigation, it may be particularly important to ensure that they are exposed to the risks of having all costs awarded against them. Finally, if a club good model is adopted for funding purposes, in principle the members of the club should determine the quantum of the activity. Further, membership of the club should be voluntary. If membership, or the level of subscriptions, is to be mandatory it is likely that the service is really a public good.

## 6.0 Consolidation of legislation and regulatory bodies

6.1 We agree with the Paper that there is a real concern about the problem of scarce expertise in many fields in New Zealand. However, in our view the scarcity is most severe in respect of public policy advice and analysis. Far too many regulatory proposals in New Zealand fail to pass the basic hurdles of problem definition, statement of objective, identification of alternatives and demonstration of net benefits. All too often the approach is simply to put forward a narrow set of solutions to a perceived problem. In our view, organisations that are weak in the technical areas of economics, law and economics, and the theory of finance are also likely to be very weak in the design of public policy. The Securities Commission has been notably weak analytically, as New Zealand's experience with insider trading legislation and the takeover debate demonstrate, but it is not the only one.

6.2 In our view, consolidation may or may not bring gains. A monolithic regulator could be worse than competing regulators that allow society to experiment in less costly ways when they take different approaches. However, neither approach addresses the fundamental problem of the unsatisfactory nature of much of our legislation and the absence of effective checks and balances on the quality of new legislation.

6.3 In our view no changes should be made without much more detailed analysis.

## 7 Concluding remarks

7.1 Labour's goal is to promote investor confidence. We agree that quality regulation should assist in the achievement of this goal. Quality regulation arises either from chance or from good quality analysis. Most investors would be unnerved if they knew quality regulation could only occur by chance under Labour. Therefore their confidence about future regulation will depend, at least in part, on the quality of the analysis provided in support of Labour's regulatory proposals, both in general and in any particular case.

7.2 The proposals in the Paper give the unfortunate impression that Labour will base its regulatory proposals on narrowly conceived responses to ill-defined problems, such as the problem of 'investor confidence'. We strongly commend Labour to make less use of populist arguments and much greater use of professional analyses drawing on finance theory, public choice theory and law and economics.

7.3 Fund managers and major investment banking firms and the professional staff in major companies tend to have a high level of expertise in finance. Naive financial theories are particularly likely to reduce their level of confidence. As the above discussion illustrates, the populist arguments put forward by 'small shareholder advocates' have been especially weak from a finance theory perspective. Indeed, there is a long list of professors in finance who have questioned aspects of these regulations, and it is difficult to think of any who have been supporters.

7.4 We strongly commend Labour not to proceed with proposals that do not attract the support of leading analysts in the fields we have mentioned.

7.5 We note the view expressed in the Paper's opening remarks that Labour believes there is greater scope for more public education about the nature and function of the sharemarket. In our view, the New Zealand Stock Exchange does a good job in this area, but it should be left to its members to decide its spending priorities. The government has a role to play. Critical messages that the government needs to give are that investments are risky, that high return means high risk, and that governments cannot make investments safe for investors. The government must concern itself with the effectiveness of laws against fraud and coercion, but fraudulent schemes and fraudsters are part of the human condition that governments cannot eliminate; they can merely reduce their prevalence. Governments should tell investors, over and over again, that 'buyer beware' is their best maxim. What governments should not be doing, and have done all too often in the past, is make irresponsible statements likely to undermine the reputation of the New Zealand market in the eyes of the world – for example, proclaiming to the world that New Zealand is "the last frontier of the Wild West". New Zealand's commercial laws have always been based on English law and are not out of line with good international practice. Problems that emerge should be addressed wisely and expeditiously.

7.6 Finally, we applaud the comment on page 3 of the Paper that Labour recognises that these are complex and technical issues and will take a careful approach "in full consultation with the finance and investment industries". In this context, we draw Labour's attention to the Ministry of Commerce's 3 May, 1999 summary of opinions on these and related matters at the Business Law Forum it held in March this year.

We stress that it is a summary of the views of a substantial business forum, not of the Ministry of Commerce. The conclusion of the Forum was that "The code should be buried for good".

7.7 A recurring theme in this summary is concern about the excessive costs and uncertainties arising from existing securities regulation. Regulations are outdated, do not take modern business practices into account, and overlap unsatisfactorily. The summary questions the basis of existing insider trading law and the uncertainties that surround its provisions. It refers particularly to the uncertainty it creates for pre-prospectus publicity. Enforcement is also questioned. The summary draws, at paragraph 54, the unequivocal conclusion that:

> A general review of the Securities Act 1978 should be undertaken, including the question of its application to secondary markets.

An equally clear conclusion emerged about the takeover code (paragraph 59):

> The significant number of takeovers indicates that the voluntary regime appears to be working well. "The code should be buried for good."

7.8 Public sector resources capable of handling these issues are scarce. The parliamentary legislative timetable is also usually a constraint. We do not believe that any credible case can be made that the weight of professional opinion in the finance and investment community would see implementing a takeover code as a priority. Nor should Labour simply address issues of enforcement of insider trading laws when it is abundantly clear that the law itself needs a fundamental review.

**NEW ZEALAND BUSINESS ROUNDTABLE**

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# SUBMISSION ON THE MINISTRY FOR THE ENVIRONMENT'S

## *CLIMATE CHANGE: DOMESTIC POLICY OPTIONS STATEMENT*

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**APRIL 1999**

## Summary and recommendations

1 This submission on the Ministry for the Environment's January 1999 consultation document *Climate Change: Domestic Policy Options Statement* (the Statement), 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.

2 In our view the Statement is seriously deficient. Its first major deficiency is its failure to point out that the proposed measures will not remedy the problems that motivate them, even if all countries achieve their targets. The measures will impose real economic costs on the community for no discernible environmental benefits.

3 Its second major deficiency is its lack of a sound analysis of what becomes, by default, the critical issue behind the proposals – international credibility. No attempt is made to establish the precise nature of the alleged diplomatic benefits of the proposed measures or to demonstrate that they meet them at least cost.

4 Its third major deficiency arises from its failure to consider the welfare of New Zealanders at large. No real consideration is given to the possibility that New Zealanders might be better off if the projected global warming took place than if significant costs are incurred in a possibly futile effort to abate it.

5 Finally, we are concerned that the Statement and a related newsletter from the Ministry for the Environment fail to acknowledge significant scientific controversy and disquiet about the viewpoints they so unreservedly express. Far from taking a balanced, objective and consumer-welfare-driven view of the science, these documents appear to be so one-sided and rhetorical as to amount to environmental advocacy. In our view, government agencies should be endeavouring to ensure that the public is well informed about the many uncertainties that surround the more alarmist claims being made about global warming.

6 Reflecting these deficiencies, the proposals would involve, in our view, a potentially large economic cost for an unspecified diplomatic benefit. This surely represents a major public policy failure in the making. No government policy actions would be credible and politically sustainable on such a basis.

7 First, we recommend that the government explicitly acknowledges that New Zealand is too small for its actions to affect the global climate. It should return therefore to its earlier policy of refusing to adopt policies that amount to unilateral action. Any decisions by New Zealand to take substantive action should be conditional on decisions by the world's major emitters. We doubt whether New Zealand should spend resources putting in place the structures necessary for a carbon tax or emissions trading if it is not diplomatically necessary to do so.

8 Second, we recommend that the government not ratify the Kyoto Protocol (the Protocol) unless doing so is imperative for diplomatic reasons. As long as it remains problematic whether the United States will ratify the Protocol, its entry into force is not a forgone conclusion.

9 Third, we recommend that the government obtain a high quality analysis of the international diplomatic aspects of the issue. This should explicitly consider the likely intentions of Australia, Canada, the United Kingdom and the United States in relation to the international commitments they have made to date. Options for New Zealand should be assessed in the light of this analysis.

## 1 General Comments

1.1 This submission on the Ministry for the Environment's January 1999 consultation document *Climate Change: Domestic Policy Options Statement* (the Statement), 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 NZBR's longstanding views on this issue were summarised in our 31 October, 1996 submission on the Working Group on $CO_2$ Policy's discussion document *Climate Change and $CO_2$ Policy*. They have not changed. Nor has a proper analysis yet been done of the costs of adjusting to climate change compared with the costs of attempting to prevent it. Briefly, no convincing case has yet been made that New Zealanders would be worse off if the projected global warming to 2100 took place. Nor is there yet evidence internationally of the very substantial political determination and capacity necessary to implement policies likely to be draconian enough to materially affect the projected global warming. Unless this situation changes, New Zealand must expect to have to adapt to any climate change as it occurs. In the meantime it must balance the economic costs to the community of inevitably ineffectual climatic measures against any diplomatic costs of not introducing them.

1.3 We understand that the government could determine its decisions in the light of the Kyoto Protocol (the Protocol) in the next few months. Any material measures impose costs. In contrast, none of the domestic policy responses considered in the Statement can conceivably affect global or local climate change trends. New Zealand is too small and the targets in the Protocol are too limited. For example, one reviewer reports that:

> According to the best computer model from the National Centre for Atmospheric Research, the Kyoto agreement, even if signed by all the nations of the world, would reduce global warming by an infinitesimal 0.18 degrees Celsius over the next fifty years.[1]

1.4 The first issue the government needs to address is the rationale for ratifying the Protocol at all, given the current indications that poor countries have other priorities, the US Senate's opposition and the absence of any material environmental benefits from the proposed measures. The government's original policy of not taking unilateral action is the only sensible policy for a small country to take. It unwisely compromised this position in its (since deferred) pledge to bring in a carbon charge in 1997 depending on circumstances that were not conditional on what other countries were doing. The government should revert to its original policy.

1.5 The second issue the government should address is the impact of global warming on consumer welfare. Currently it has not been established that New Zealanders at large would be worse off if the projected global warming were permitted to occur. Benefits would presumably include fewer cold-related deaths and illnesses, less fuel for winter heating and longer hours of outdoor leisure activity. Agriculture might benefit from longer growing seasons and greater atmospheric carbon dioxide. Far from making a balanced assessment of the mainly overlooked benefits against the heavily emphasised costs, the Statement simply ignores the issue of overall consumer welfare.

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1 Jerry Taylor, 'Clouds over Kyoto: The Debate over Global Warming', *Regulation*, Vol 21, No 1, Winter 1998, pp 57–62.

1.6 Furthermore, even if a good case could be made that New Zealanders at large would regard themselves as worse off if the projected warming occurred, the case would still need to be made that the costs of abatement would not be greater.[2] This has not been done.

1.7 This indifference to the welfare of New Zealanders at large makes the proposed policy approach fundamentally elitist. The general public is essentially being told that its welfare is irrelevant. New Zealanders are being led to believe that they must incur costs because the New Zealand government has made, or wants to make, international commitments. The disjuncture with the attitude taken to New Zealand's international credibility when the nuclear-free zone issue was being debated is jarring.

1.8 One defence of the measures in the Kyoto Protocol might be that they represent the best immediately achievable step towards future measures that would make a difference to the global climate. This is a judgment about future climate change politics. Such political judgments should be based on sound analysis. A serious analysis would have to assess the reasons for the current resistance by the United States and non-Annex I countries to the pursuit of even the limited targets currently proposed. This resistance will surely be greatly increased in the face of much more costly measures.[3] The problematic and tentative nature of the predicted climatic changes and their effects on human welfare will come under increasingly sceptical scrutiny. The costs of adapting to projected warming can also be expected to receive greater attention.

1.9 Nowhere does the Statement acknowledge that the contemplated policies will not prevent the purported environmental detriments. It does not note that even if the United States and non-Annex I countries adopted the Protocol, the actions envisaged would not prevent the adverse environmental effects that are their only justification. Nor does it inform readers that the US Senate has passed a resolution opposing ratification of the Protocol, as matters stand at present. Nowhere does it acknowledge that significant uncertainties and disagreements exist about the science (see section 2 below). The rationale for unilateral action by New Zealand, or even of ratification in the face of the above considerations, is not discussed. It is of grave concern that the Statement is seriously deficient in so many respects.

1.10 The Ministry for the Environment's January–February 1999 newsletter only serves to confirm the impression created by the Statement that (too many) officials have adopted a position of uncritical and one-sided advocacy in relation to this issue. The newsletter makes sweeping assertions about environmental detriments while ignoring all possible benefits and scientific uncertainties and controversies. It cavalierly asserts that there is "... increasingly clear evidence that climate change is caused by rising concentrations in the atmosphere of greenhouse gases resulting from human activities ... ." (but such statements merely beg the questions of materiality and authority. In whose opinion is it "increasingly clear", why should such views be regarded as authoritative when other experts disagree, are any adverse effects material in the light of other influences on the global climate, and do they outweigh beneficial effects?). It also contentiously cites the warmer global

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2 The Competitive Enterprise Institute has recently released a study by Professor Frank Gross, *Could Kyoto Kill? The Mortality Costs of Climate Policies*. This paper argues that the measures that could be required to meet the Protocol's targets could increase highway fatalities, worsen indoor air pollution and increase poverty-related deaths.

3 According to William Niskanen in testimony to the Senate Committee on Energy and Natural Resources on 30 September, 1997, economist John Nordhaus estimated the net costs of stabilising the concentration of greenhouse gases at US$12.5 *trillion* in 1989 dollars.

temperatures in 1997 and 1998 in support of the climate change hypothesis[4] and uses estimates of the costs of a naturally occurring phenomenon, El Nino, to convey the impression that the proposed measures will be efficacious in reducing climatic variability. The essence of this approach is to assert that there may be a connection even if the direction of any effect is unclear or even if it may be equally plausible to say that there may be no material connection. In a highly complex situation in which everything may be connected to everything else, no matter how tenuously or indeterminately, one-sided assertions are cheap but dangerous. Again no mention is made of the fact that the proposed Kyoto measures will fail to solve any of the alleged problems. It is difficult to avoid the conclusion that the Ministry has lapsed into one-sided advocacy and rhetoric. It appears to be seriously failing to give objective and balanced analysis and advice. The government surely deserves better, and the public at large certainly do.

1.11 What decisions might ministers soundly take? Any measures that the government might announce would have a trivial effect on the global climate. Any credibility they derive arises from their impact on New Zealand's standing internationally. *A careful analysis of the international politics of global climate change agreements is clearly required*. This analysis should point to options that could usefully raise or protect New Zealand's international standing at minimum cost. The choice between such options will depend on the balance between their economic cost and their diplomatic benefits. Such an analysis would require consideration of the responses of other countries (such as Australia, Canada, the United Kingdom and the United States). It would also require consideration of other international initiatives involving New Zealand that could have a compounding or mitigating effect.

1.12 Section 4.3 of the Statement discusses the international credibility issue. The discussion comprises only four paragraphs. None mentions the likely responses of other countries. None assesses the issue of what responses by New Zealand would best meet the credibility objective at least economic cost. None raises the issue of compounding or mitigating factors from unrelated diplomatic activities. One paragraph does mention small Pacific Island countries that could be at risk from global climate change. But this paragraph completely fails to consider how best to deal with the potential problems of such countries at least cost. For example, it fails to consider what diplomatic advantages might accrue if New Zealand offered to open its borders to the citizens of these countries should international action to offset global warming prove ineffectual.

1.13 Reflecting these factors, the NZBR continues to believe that unilateral actions by New Zealand would be unjustified and premature. Any decisions taken by the government should be explicitly conditional on decisions taken by other Annex I countries, notably – given its size – the United States.

1.14 We express this view in the knowledge that the projections in the Statement give rise to the possibility that New Zealand could benefit from being a net supplier of carbon credits. This would occur if New Zealand's credits from carbon sinks exceeded its requirements in terms of the growth in emissions (refer to chapter 3 in the Statement) and if New Zealanders could sell the excess to non-New Zealanders. However, in our view it would be premature to put much reliance on the possibility that the countries that stand to benefit from carbon sinks will have the political clout to transfer material amounts of wealth from other countries in this manner. Being seen to advocate such transfers would not be consistent with the allegedly critical policy objective of enhancing New Zealand's international credibility. Furthermore, it could

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4 We understand that Jerry Mahlman, a modeller and Gore adviser, has publicly denounced attempts to link the warmth of 1998 to global warming. See also Patrick Michaels, 'Long Hot Year: Latest Science Debunks Global Warming Hysteria', *Policy Analysis*, 31 December, 1998, Cato Institute.

be difficult to restrict any benefits to New Zealand owners of New Zealand forests (rather than non-New Zealand owners).

1.15 Since the Statement fails to analyse the implications of the issue for New Zealand's international standing, no environmental or diplomatic case has been made for any measures to be implemented at this stage. The government should require a careful analysis of its diplomatic objectives. This should identify relevant options for New Zealand in the light of those objectives. The economic costs and benefits of those options should be assessed by those who are competent to do so. An informed judgment might then be made as to which options involve the best compromise between economic cost and diplomatic gain. Such a procedure would provide a much better basis for public consultation and debate, and for subsequent government decision making.

1.16 One important point that does emerge from the material reviewed in making this submission is that the government may have a useful role to play in reducing the amount of misinformation that exists on global warming. The issue has attracted highly emotional and alarmist comments. Arguably, sound science has lost out to populism in the public mind. There is also some evidence that it is affecting the views of scientists (see paragraph 2.5 below). Dissenting scientist Richard Lindzen has commented on the issue in the following terms:

> Public perceptions, under the influence of extensive, deceptive, and one-sided publicity, can become disconnected from reality. For example, Alabama has had a pronounced cooling trend since 1935. Nevertheless, a poll among professionals in Alabama found that about 95 percent of participants believed that the climate had been warming over the past fifty years and that the warming was due to the greenhouse effect. Public misperceptions coupled with a sincere desire to "save the planet" can force political action even when politicians are aware of the reality.[5]

1.17 It is surely conceivable that the Ministry for the Environment is contributing to such information and perception problems. In our view the government has a responsibility to prevent the public debate from being unduly influenced by special interests within the bureaucracy. The Ministry for the Environment is not well placed to undertake a dispassionate, consumer-welfare-driven approach to these issues, and it is highly desirable that the careers and funding of the government's scientific and diplomatic advisers do not become overly dependent on the level of public concern about this issue.

## 2 The science of global warming

2.1 The Statement, on pages 20–21, briefly reiterates summary views of the science of global warming. These views are extracted uncritically from the summaries for policy makers of the Intergovernmental Panel on Climate Change (IPCC) Working Group reports. The fundamental problem here is that officials appear to be proceeding on the basis that disputes amongst scientists over the science of global warming do not have to be acknowledged. No account is taken of the controversy surrounding such summaries, or even of the qualifications to them that may be inferred from other IPCC material. For example, the Statement cites the IPCC's conclusion that "the balance of the evidence suggests a discernible human influence on global climate" but, unlike Taylor, it does not cite other statements in the same document that clearly question such an unqualified assertion.[6] In any case, this statement fails to cast any light on the materiality or direction of any effects. Officials

5 Richard S Lindzen, 'Global Warming: The Origin and Nature of the Alleged Scientific Consensus', *Regulation*, November, 1996.

6 Taylor, *op cit*, p 59.

also cite uncritically claims that global warming will have significantly adverse *net* effects on agricultural productivity, human health and weather variability.[7]

***The 'consensus' issue***

2.2 No assertion about the consensus of opinion can overcome the uncertainty which stems from valid disagreements about the science. The Statement gives the impression that the IPCC's 'discernible human influence' finding is both beyond dispute and significant in public policy terms. Neither proposition appears to be valid. On the first point, chapter 8 of the related IPCC Working Group I report observes that:

- "The answer to this question [of when the detection and attribution of human-induced climate change is likely to occur] must be subjective, particularly in the light of the large signal and noise uncertainties discussed in this chapter."

- "Some scientists maintain that these uncertainties currently preclude any answer to the question posed above. Other scientists would and have claimed, on the basis of the statistical results presented in Section 8.4, that confident detection of a significant anthropogenic climate change has already occurred."

- "... few would be willing to argue that *completely unambiguous* attribution of (all or part of) this change has already occurred, or was likely to happen in the next few years."

- "Our ability to quantify the magnitude of this effect is currently limited by the uncertainties in key factors, including the magnitude and patterns of longer-term natural variability and the time-evolving patterns of forcing by (and in response to) greenhouse gases and aerosols."

As this material acknowledges, the unqualified conclusion cited in the Statement cannot be represented to be an objective scientific finding. Rather, it is a statement of the authors' subjective judgments as to which scientific opinions they wished to emphasise. The basis for their preference is not spelt out in chapter 8.

2.3 In any case it is not important for human welfare whether or not the IPCC's conclusion is correct in the terms in which it is expressed. There is a sound scientific basis for predicting some global warming in due course, even if its effects are not yet apparent. Rather, the central issue is how much warming will occur taking natural variability into account, how it will be distributed through time and space, and how harmful it will be, having regard to opportunities to mitigate its effects. This particular, much-cited, IPCC conclusion fails to provide any useful information about such matters.

2.4 Other material throws some light on these more important questions. For example, one survey, conducted in 1996, of 1,000 scientists in Germany, the United States and Canada found that:

- most of the respondents were not optimistic about the predictive ability of the current state of scientific knowledge to provide reasonable predictions of climate variability over time scales of 100 years;[8]

- "... the scientific community tends towards the position that we cannot yet explicitly state the detrimental effects that climate change may bring"; and

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7 See, for example, the Ministry of Commerce's pamphlet 'Climate Change: What You Should Know', March, 1999, pp 1 and 7.

8 The mean response to this question was 5.2 (where 1 = a great degree of ability; 7 = not at all).

- "... there is some agreement that global warming is a process already underway but there is a greater tendency to agree that it is a prospect for the future."[9]

2.5 Interestingly, there was a consensus among the same respondents that "climate change has provided enough knowledge so that the initiation of abatement measures is warranted". As the authors of the paper noted, such judgments reflect the views of the scientists about matters outside their expertise, such as the effect on humans, their ability to adapt, and the costs of adaptation relative to the costs of abatement. They note the incompatibility between the uncertain state of knowledge about the science and the willingness to call for abatement action. They conclude that scientists may be being influenced by the social and political context of their work. (It is noteworthy in this context that the president of the National Academy of Sciences reportedly felt compelled at its 1990 annual meeting to warn the membership against lending their credibility to issues about which they had no special knowledge.)

2.6 The same survey found that US scientists were less convinced of the merits of the models than were their German counterparts and (consistently) saw a less urgent need for a policy response. This may be consistent with the following observation from the paper by Lindzen cited above:

> Indeed, a recent Gallup poll of climate scientists in the American Meteorological Society and in the American Geophysical Union shows that a vast majority doubts that there has been any identifiable man-caused warming to date (49 percent asserted no, 33 percent did not know, 18 percent thought it had occurred; however, among those actively involved in research and publishing frequently in peer-reviewed research journals, none believes that any man-caused global warming has been identified so far).

2.7 The pressure to suppress the problem of genuine scientific uncertainty by recourse to reliance on a single 'consensus' position has led to a myriad of polls canvassing the opinions of groups on the issue. Problems of bias and the respondent's lack of expertise may arise. Nevertheless, with this caveat, it needs to be recognised that thousands of individuals with a scientific background appear to be unconvinced by claims of serious global warming. For example, Taylor reports that over 4,000 scientists signed the so-called Heidelberg Appeal that expresses the view that no compelling evidence exists to justify controls of anthropogenic greenhouse gas emissions. Peter Hartley, Ken Medlock and Michael Warby[10] also cite sceptical statements signed by groups of scientists in early 1992, mid-1996 (the so-called Leipzig declaration) and early 1998 (the Oregon petition).

2.8 Such disputes about the science should occasion no surprise given the complexities of the science of the atmosphere, the degree to which existing models must over-simplify reality, and the relatively short number of years in which research has focused on greenhouse gas issues.

***Fears of much-increased precipitation***

2.9 According to the IPCC, global rainfall has increased by about 1 percent during the twentieth century, although the distribution of this change is not uniform either geographically or over time.[11] Data are a problem, suggesting that the statistical

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9 Dennis Bray and Hans von Storch, 'Climate Science: An Empirical Example of Postnormal Science', *Bulletin of the American Meteorological Society*, March, 1999, pp 439–455.

10 Peter Hartley, Ken Medlock and Michael Warby, 'First Things First: Development and Global Warming', unpublished draft paper 1999.

11 As cited by Jerry Taylor, *Global Warming: The Anatomy of a Debate*, 16 January, 1998. Presentation to the John Hopkins University Applied Physics Laboratory.

reliability of this observation may also be in doubt. Increased average precipitation could benefit many farmers, particularly in conjunction with a warmer average temperature and greater concentrations of carbon dioxide.

***Fears of much-increased temperatures***

2.10 Observed global temperatures have remained far below those predicted by the computer models that served as the basis for the United Nations Framework Convention on Climate Change. What warming has occurred appears to have been extremely moderate and benign, being largely confined to the cold northern latitudes during winter nights.[12] There appears to be no doubt that the earlier IPCC estimates have been discredited and that current predictions of warming are much more modest.

**Decline in Median Projected Climate Warming**

| *Estimate* | *Value* |
|---|---|
| IPCC 1990 initial estimate | 3.2°C (5.7°F) |
| IPCC revised 1992 estimate | 2.6°C (4.7°F) |
| IPCC revised 1995 estimate | 2.0°C (3.6°F) |
| After allowing for overestimation of direct $CO_2$ warming | 1.75°C (3.2°F) |
| After allowing for flattening of methane concentration | 1.5°C (2.7°F) |
| After allowing for decrease in $CO_2$ accumulation | 1.25°C (2.3°F) |

2.11 Patrick Michaels, a dissenting environmental scientist, believes that recent evidence on the direct effects of carbon dioxide warming and likely lower levels of atmospheric methane and carbon dioxide will lead to further reductions in projected warming. The table above summarises in the last three rows his view of what should be projected. These predictions differ markedly from the single prediction cited by the Statement of further warming of about 3°C by 2100. Disturbingly, the Statement does not acknowledge the existence of such a wide range of views.

2.12 Would such warming be a problem? Not necessarily. Thomas Gale Moore of the Hoover Institution and Stanford University has estimated that moderate warming would generate net benefits for the United States of about 1 percent of total output. He has also argued that it would be likely to produce material health benefits.[13]

***Fears of much-increased sea levels***

2.13 Taylor reports that while there is some evidence that sea levels have risen 18 cm during the past century (with an uncertainty range of 10–25 cm), there is little evidence that the rate of rise has accelerated, contrary to global warming theories. Lindzen comments:

> Many aspects of the catastrophic scenario have already been largely discounted by the scientific community. For example, fears of massive

12 See Jerry Taylor, 16 January, 1998.

13 Thomas Gale Moore, 'Why global warming would be good for you', *The Public Interest*, Winter 1995, pp 83–99; and 'Life, Death and Climate', in World Climate Report – Health and Economics, mimeographed.

> sea-level increases accompanied many of the early discussions of global warming, but those estimates have been steadily reduced by orders of magnitude, and now it is widely agreed that even the potential contribution of warming to sea-level rise would be swamped by other more important factors.[14]

*Fears of extreme weather variability*

2.14 While the Ministry for the Environment acknowledges uncertainty about the degree of climatic variability, it is putting a lot of emphasis on the alleged "identification of potentially serious changes". However, again the body of the IPCC's 1996 report expresses more caution about such assertions than the Statement's extracts imply. For example, Working Group I's detailed report includes the following qualifying observations:

- "In the few analyses available, there is little agreement between models on changes in storminess that might occur in a warmer world. Conclusions regarding extreme storm events are obviously even more uncertain."

- "The data on climate extremes and variability are inadequate to say anything about global changes ... . "

- "Other than the few areas with longer term trends to lower rainfall (eg the Sahel), little evidence is available of changes in drought frequency or intensity."

2.15 Michaels and some colleagues have found a statistically significant *decline* in the interannual worldwide variability in temperature since 1945. In addition, they have found no statistically significant changes in day-to-day temperature variations or in the number of record high or low temperatures. Michaels also cites research into the rate of flow of streams by Harry Lins and J R Slack of the US Geological Survey which finds no change in the frequency of highest flow (flood) events, and a decrease in the frequency of lowest flow (drought) events.

2.16 In personal correspondence Professor Lindzen sums up his perspective on the issue of climatic variability as follows:

> Finally, with respect to variability, there is the trivial fact that variability in the extratropics is proportional to the temperature difference between tropical and high latitude regions, and that this is expected to be smaller in a warmer world. There is absolutely no evidence in observations, theory, or modeling for any claim to the contrary. The claim of the opposite is simply a political statement that the public doesn't seem to find slight warming all that frightening. One therefore makes up something that might sound scarier. The argument is sometimes put forward that storminess would increase because of a more intense hydrological cycle. Not only is there no evidence for an increased hydrological cycle, but such an increase, if it were to exist, would be largely irrelevant to extratropical variability.

2.17 This material appears to indicate that scientists can be a lot more confident that the build-up in greenhouse gases will lead to some warming (relative to whatever temperature changes would actually take place as a result of natural variability, including unforeseen events) than about the proposition that we are entering a world of generally increased variability, unpredictability and peril. Indeed, there appears to

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14 Lindzen, *op cit*.

be some empirical evidence, and at least one scientific argument, for the contrary proposition.

2.18 Given that the IPCC reports that some natural phenomena that are important to forecasting natural variability are not well handled by current models, it is even less clear what is likely to happen to actual global average temperatures by 2100. Effects on human activity depend on what happens to actual temperatures.

## 3 Least-cost policy options

3.1 A least-cost policy is one that meets a given policy objective at least cost. The least-cost policy cannot be objectively determined when there are conflicting policy objectives and no objective means of trading them off.

3.2 On page 37, the Statement proposes the following objectives for policy choices:

- contribution to the least-cost policy objective[15]
- international credibility
- equity
- practicality and durability
- flexibility.

3.3 While the least-cost objective may well be consistent with achieving a given reduction in emissions at least cost, it may not be consistent with achieving a satisfactory level of international credibility at least cost. (Refer, for example, to the discussion above of one possible response to the problems of small Pacific Island nations.)

3.4 The emphasis in the Statement on the least-cost objective reflects its failure to treat the Protocol as a political document and to concern itself with the interests of New Zealanders at large. If many New Zealanders would regard themselves as better off under projected global warming, the case for taxing them in order to satisfy the interests of other countries must be made rather than assumed.

3.5 In short, the Statement completely fails to establish that the policy proposals represent the least-cost response to the political problems posed by the Kyoto issue.

## 4 Proposed policy options

4.1 In principle, a given target for emissions will be achieved at least cost if the marginal cost of reducing emissions is the same across all activities. This optimal result could be obtained by a uniform carbon tax or by tradable permits. Grandparenting arrangements would not produce a least-cost outcome if they failed to meet this condition. However, grandparenting in the form of grants of tradable permits that allowed the recipient to close down immediately and sell the permits would be consistent with a least-cost reduction in emissions.

4.2 The issue of equity, viewed as a compensation or income distribution issue, is logically distinct from the issue of efficiency. Given that none can be excluded from the benefits of the hoped-for avoidance of climate change, and that the benefit any

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15 The least-cost objective is defined as an approach that provides an equal incentive to reduce all carbon dioxide equivalent emissions.

individual derives does not obviously detract from the benefit that any other individual can enjoy, climate change policies have the attribute of a public good. In general it is inequitable to tax a few for benefits that will accrue to the public at large. This is illustrated by the common adage that "those who benefit should pay". This approach is consistent with the Public Works Act 1981. Under this Act, it would be illegal for the Crown to take land by force for public works without compensation.

4.3 As Richard Epstein has cogently argued, there are also efficiency arguments for requiring compensation to those from whom property is taken in the interests of the wider community.[16] The benefits of paying compensation relate to the desirability of preserving the rule of law and forcing those who would take for the benefit of others to balance the costs against the benefits. Motorists could, for example, be compensated for the present value of any increases in petrol taxes through reductions in periodic licence or registration fees (or even in the form of negative fees). The incentives to use less fuel would be much the same.

4.4 Where a policy change allows the owner of a sink to sell permits, the same issue arises. In this case the question is whether any compensation to the emitter for the takings should be funded in whole or in part by the owner of the sink. In principle there is a case, where the benefits from a policy are not evenly distributed across individuals, for requiring those who benefit disproportionately to contribute disproportionately to compensating losers. This is what could be expected to occur if the transaction could be conducted privately without the active intervention of the Crown and where the common law protects the property rights of losers. Difficulties arise in determining what proportions will apply and in controlling any government's innate interest in expropriating a greater share of the benefits than is required to compensate losers so as to use the excess to buy votes.

4.5 The practical difficulties involved in applying the principles just discussed may be insurmountable in many cases. This is a matter that can only be determined by a careful examination of the circumstances applying to any given case.

4.6 In the NZBR's view, the case for any regulatory takings in respect of global climate change is currently so weak that requiring the issue of compensation for takings to be specifically addressed could promote a more rigorous discussion of whether regulatory interventions are warranted at all.

## 5 Concluding comments

5.1 In the current climate of opinion, virtually every out-of-the-ordinary weather event seems likely to be linked in the popular media to global warming. Those in positions of authority have a responsibility to do their best to ensure that public debate on these issues is not unduly influenced by alarmist views. This means informing the public about the tentative nature of much of the science and therefore of any implications for human welfare.

5.2 It is disturbing to find instead that the Statement and associated documents are failing to convey the range of reputable scientific opinion about many of these issues. Arguably, they also lend undue credibility to alarmist and populist propositions by failing to distinguish adequately between relationships that may be a remote possibility, and relationships that are considered by scientists to be more plausible than competing and contradictory hypotheses and are quantitatively material. A more sober approach is surely warranted.

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16 Richard A Epstein, *Takings: Private Property and the Power of Eminent Domain*, Harvard University Press, Cambridge, Massachusetts, 1985.

5.3 Populist agitation over the global warming issue in recent years has threatened the development of objective science and sound public policy. The reductions in the IPCC's projections for global warming point to the tentative nature of the science and the folly of over-reacting to preliminary findings.

5.4 Sceptical scientists are making strong claims that recent climate trends are not consistent with the predictions that have so far driven policy-makers. For example, Patrick Michaels concluded his review of trends in the satellite records of temperatures and of trends in climate volatility as follows:

> The observed data on climate and recent emissions trends clearly indicate that the concept of "dangerous" interference in the climate system is outmoded within any reasonable horizon. That makes the Kyoto Protocol a useless appendage to a treaty that has been bypassed by scientific discovery. It is time to reconsider the Framework Convention.

5.5 In this submission we have focused on presenting scientific material that dissents from the views embodied in the Statement. Our purpose in doing so is primarily to demonstrate the point that the views about the science that the Statement presumes can be taken as given are in fact much more controversial than the Ministry for the Environment appears to be prepared to acknowledge. We claim no expertise in adjudicating debates between scientists about scientific matters. However, we are concerned that officials present these controversies objectively in the interests of informed public debate.

**AIC LAND TRANSPORT CONFERENCE**

# TRADE, INTERNATIONAL COMPETITIVENESS AND THE NEW ZEALAND TRANSPORT INDUSTRY


**ROGER KERR**
**EXECUTIVE DIRECTOR**
**NEW ZEALAND BUSINESS ROUNDTABLE**


**WELLINGTON**
**19 MARCH 1999**

# TRADE, INTERNATIONAL COMPETITIVENESS AND THE NEW ZEALAND TRANSPORT INDUSTRY

No discussion on trade and international competitiveness at this time can overlook the increased uncertainty of the world economy associated with recent turbulence in international financial markets. Several questions have been raised concerning the appropriate government response to increased uncertainty. Should New Zealand reduce its involvement in international trade? Should the government be attempting to influence the pattern of trade or the composition of exports? How can New Zealand achieve and maintain international competitiveness in the face of financial market volatility? Does increased uncertainty have any particular implications for reforms in the transport sector?

Before considering these questions, it might be useful to look at some of the current features of the international trading environment.

**The shape of the world economy**

Some widely respected commentators are painting a gloomy picture about the short-term future of the world economy. In the view of *The Economist*:

> The world economy is precariously lop-sided. Even as America's economy continues to surge, much of the rest of the globe is drifting towards deflation. It is scary that America's boom, fuelled by an unsustainable stock market, is now the main prop for global demand. For how much longer? Global deflationary pressures are already choking America's profits, making its share prices look ever more overvalued.[1]

Robert Samuelson, a respected commentator on economic matters, has recently devoted his column in the *Washington Post* to a discussion of opposing views about the implications of the decline in the US savings rate. His conclusion is also worth quoting:

> My bias lies with the pessimists. The US economy may be surfing on its own euphoria. Overpriced stocks cause consumers to overspend and businesses to overinvest – and none of it can last. The optimistic interpretation is that we're merely witnessing the advent of a new, unfamiliar pattern of thrift. Either way, low personal saving is an essential catalyst of the present boom. If saving somehow were to rise, the American and world economies would face even greater peril.[2]

These assessments should not be lightly dismissed. Shocks happen, economic growth fluctuates and sharemarkets are risky and volatile. However, these risks should be kept in perspective. Even if events dash the expectations of large numbers of investors, this would not necessarily have serious implications for the growth prospects of the United States or other countries over the next decade. The "peril" – if there is one – is the risk that policy responses to short-term problems in some major countries will be inappropriate and make the adjustment process unnecessarily difficult and protracted. The key issue here is the need for governments to make continuous efforts to make their economies more open and flexible. The reform agenda is never-ending, particularly with the advent of globalisation. New Zealanders should not feel sanguine given the slowdown in the momentum of economic reform and the policy mistakes of the last six years.

However, we should not lose sight of the fact that, despite these worries, the world economy is in much better shape than it was during the stagflationary years of the 1970s.

1 *The Economist*, 20 February, 1999, pp 15–16.
2 Robert J Samuelson, 'Hell No, We Won't Save!', *The Washington Post*, 17 February, 1999.

There is no doubt that the growth in prosperity in the United States during the 1990s has been largely attributable to better policies and the spirit of enterprise and innovation that marks its economy – factors which will continue to exert a positive influence in the years ahead.

There are also good reasons to be moderately optimistic about the economic prospects of many countries in Asia over the next decade, despite the setbacks in some of them. These set backs appear to have had their origins largely in poor government policies – including fixed and over-valued exchange rates and other financial market controls, activist industry policies and a lack of transparency in banking and corporate governance. Although there are some exceptions, the general response of these countries to the economic crises has been to implement further market-oriented policy reforms which will place them on a firmer footing. It is less clear whether the major economy in the region, Japan, is yet facing up to the changes needed to restore economic growth.

**Responding to uncertainty in the world economy**

One possible response to uncertainty in the world economy is to reduce New Zealand's involvement in it. A reversion to protectionism has been suggested by Tim Hazledine of the University of Auckland. He argues that if we were less dependent on trade and investment with the rest of the world, we would be able to set ourselves "an economic course more resistant to buffeting from events outside our control".

Those who advocate a move back to isolationism are promoting a recipe for certain impoverishment, no matter what happens to the world economy. People who are not prepared to risk some buffeting from events beyond their control can expect mediocre returns on their resources. If we refrain from selling goods to foreigners because we cannot be sure that they will always be willing to buy them at favourable prices, we are likely to miss out on profitable export opportunities. Similarly, if we are not willing to borrow because of the risk that lenders may require their money back at an inconvenient time, we are likely to miss out on profitable investments.

Individuals and firms can make their own choices as to whether their exposures to world markets are worthwhile. Some may decide that the best strategy is to 'batten down the hatches' and wait for the storm clouds to go away – to sacrifice some potential income in order to achieve greater security. That is their choice. Others will be willing to accept greater risks in order to take advantage of emerging opportunities. The information needed to make sensible choices about risk is in the hands of firms and individuals, rather than governments.

Another common response to uncertainty is to suggest increased regulation. Popular candidates for regulation are international capital flows and greater regulation of the lending policies of banks. The fact that Chile maintains some controls on short-term capital movements is frequently mentioned by advocates of controls. But Chile's short-term interest rates have been five times more volatile than those in Argentina, which abolished all capital restrictions in the early 1990s. The introduction of capital controls exacerbated the 1930s depression, and there is no reason to believe the effects of such measures today would be different. Open capital markets help put pressure on governments to modify bad policies and safeguard the interests of domestic and foreign investors alike.

**The pattern and composition of trade**

Is there any reason to believe that changes in the pattern of trade have made New Zealand excessively vulnerable to the recent reversal of economic fortunes in several Asian countries? This seems unlikely. The percentages of exports going to Japan and other Asian countries have fluctuated over time, but were not much higher in 1996 than in 1980. (The percentage of the total value of exports going to Japan increased from 13 percent to 15 percent and from 18 percent to 21 percent for other Asian countries.) The share of New Zealand's total trade with Asia remains substantially lower than that of Australia.

The most noticeable change in the pattern of New Zealand's trade over recent decades is the increasing importance of Australia and declining importance of the United Kingdom, both as destinations for exports and sources of imports. Exports to Australia have risen to over 20 percent of total exports in recent years and imports from Australia account for around 25 percent of total imports. By contrast, Britain now accounts for only 6 percent of exports and 5 percent of imports. These changes reflect the fact that the extent to which countries trade with each other normally depends heavily on geographical proximity.

In 1960, when exports to, and imports from, the United Kingdom respectively accounted for 53 percent and 45 percent of total exports and imports, there may have been grounds for concern that New Zealand's trade policies had encouraged too much dependence on trade with one part of the world. An underlying reason for this dependence was the preferential trade arrangements between New Zealand and Britain. These have long since been abandoned, and New Zealand's trade is now much more geographically diversified.

Similarly, New Zealand is moving away from reliance on the export of a few unprocessed commodities. There have been important changes in the composition of exports over the last decade. In particular, the volume of non-food manufactured exports has increased at 8 percent per annum, about double the rate of increase in the volume of total exports over the past decade, and now accounts for 36 percent of the value of all exports. The proposed dismantling of producer board controls would accelerate the shift away from commodities.

**Getting and staying competitive**

A few years ago, Paul Krugman expressed the view that the notion of 'competitiveness' was, at best, meaningless and, at worst, encouraged protectionism when applied to national economies.[3] Competitiveness is a meaningful concept when it is applied to individual firms as, for example, when one firm gains market share relative to a competitor. At the national level, however, Krugman pointed out that the term is often misused to invoke inefficient polices, such as tariffs and tax concessions, on the grounds that they can improve the international competitiveness of particular industries. The proper objective of policy should be to encourage the best allocation and use of resources, not the competitiveness of specific firms or industries.

The quality and the scale of government are important for economic performance and domestic living standards. People and resources migrate to the places providing the best opportunities. Countries with poor economic policies are unattractive locations for investment and hence tend to have low rates of economic growth.

Contrary to some views, globalisation does not involve some kind of bidding war in which the freedom of action of governments is severely restricted. The reality is quite different:

- First, sound economic policies enable governments to avoid resorting to desperate measures in an attempt to foster economic activity. Where governments seem willing to make substantial sacrifices – in areas such as environmental quality – in order to encourage industrial development, economic policies are generally not favourable to growth. The environmental record of the former communist countries is a prime example.

- Second, national governments retain a large measure of sovereignty. As Douglas Myers remarked sardonically a couple of years ago, New Zealand is just as free

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3 Paul Krugman, *Peddling Prosperity*, Norton and Co, New York, 1994.

today to borrow extravagantly, debauch its currency or prop up uncompetitive industries as it was prior to 1984.[4]

- Third, as David Henderson has pointed out, "even heavily controlled economies are subject to external problems and 'crises', as was the case for New Zealand in mid-1984 and a number of earlier episodes. Indeed in so far as controls and regulations reduce the capacity of an economic system to respond to unforeseen changes, they may make the economy on balance more vulnerable to outside pressures rather than less".[5]

In the index of competitiveness published by the World Economic Forum, competitive economies are defined as "those that have the highest capacity for medium-term economic growth, taking into account their starting level of income". The index reflects a wide range of factors that impinge on growth prospects. Analysis undertaken by Jeffrey Sachs and Andrew Warner for the World Economic Forum shows the competitiveness index to have a highly statistically significant correlation with growth rates.[6] The difference between being ranked alongside the United States, in third place, rather than thirteenth, where New Zealand was ranked in 1998, is equivalent to a difference of about one percentage point per annum in growth rates. This may not seem a great deal, but if sustained over the longer term it would mean that average income levels in New Zealand would fall far below those of wealthy countries.

If the difference between a global competitiveness ranking of third and thirteenth was due to geography or history – the tyranny of distance, or some aspect of cultural heritage – we might just have to live with it. But the difference is in fact due to the slippage in New Zealand's competitiveness relative to other countries. In 1996, using basically the same methodology, New Zealand was ranked in third place. Its ranking slipped to fifth in 1997 and then to thirteenth in 1998.

The recent decline in New Zealand's competitiveness is reflected particularly in the pressures on the traded goods sector of the economy since 1995. New Zealand's real trade-weighted exchange rate rose by 28 percent over the period from early 1993 to April 1997.[7] About half of this increase occurred in the period prior to 1995 when real investment and real exports were growing strongly and business confidence was high. In that period, the upward movement of the exchange rate was a sign of a strong economy – it put some parts of the traded goods sector under pressure, but was attributable to strong growth in some export industries and investors' favourable assessments of future growth prospects. However, the real exchange rate continued to rise for a couple of years after exports and investment had begun to level off, despite an ongoing decline in New Zealand's terms of trade.

What caused this squeeze on the traded goods sector of the economy during the period from 1995 to 1997? It is not plausible to blame it on the Reserve Bank and monetary policy. Although high short-term interest rates put upward pressure on the exchange rate during this period, this was necessary to contain inflationary pressures. These reflected increased consumer and government spending. Thus while the government was continuing to congratulate itself in public on its economic policies, increased government expenditure added to the pressures on the traded goods sector and weakened the growth prospects of the economy.

While export competitiveness has improved since 1997, this has been in the context of low or negative economic growth rates. Government spending remains high and rising and is

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4 Douglas Myers, 'Why Not Simply the Best?', New Zealand Business Roundtable, 1996.

5 David Henderson, *New Zealand's External Economic Policies*, New Zealand Business Roundtable, June, 1997, p 22.

6 Executive Summary, p 28, available at: http://www.weforum.org

7 Based on the Reserve Bank of New Zealand real exchange rate index.

crowding out more efficient private expenditure. The most important thing the government could do to improve the international competitiveness of the New Zealand economy would be to return to progressive reductions in government spending as a proportion of the gross domestic product (GDP). Reducing regulatory burdens on business, such as the job-destroying rulings of the Employment Court, should also be a top priority.

**The tyranny of distance?**

It is often observed that New Zealand's geographical location – a long way from markets in North America, Europe and Asia – adds to the cost of transport and communications and reduces the benefits of international trade. It has also been suggested that the length of New Zealand and the rugged physical landscape militate against low-cost land transport.

When one looks back at New Zealand's economic performance over the last century, however, such geographical factors do not seem to have been a serious constraint. Even with the relatively primitive transport technology that existed a century ago, New Zealand was able to become one of the wealthiest countries in the world.

In addition, for much of the twentieth century New Zealand's relative economic isolation was largely the result of the tyranny of bad economic policy, rather than the tyranny of distance. The potential benefits of international trade were heavily constrained by tariff barriers, import restrictions and government policies which protected inefficient transport activities. The effects of these policies were equivalent to requiring ships to do many circuits of New Zealand – to compound the tyranny of distance – before being allowed to load or unload any cargo.

Technological changes are reducing transport and communication costs. Geoff Vazey, chief executive of Ports of Auckland Limited, has estimated that ocean freight, which now averages about 1 or 2 percent of Free on Board (FOB) prices, represents only about one-fifth of the cost prior to containerisation. The reduction in prices of international phone calls has been even more substantial over the past 30 years. Data can now be transmitted almost instantaneously over long distances at low cost, making it technically possible for many service activities to be undertaken anywhere in the world where there are people with the necessary skills.

There is probably a long way to go before the effects of lower costs of transport and communication are fully reflected in international trade, capital flows and business practices. Despite increasing globalisation, the recent growth in world trade has not done much more than restore the ratios of trade to GDP that were commonplace earlier this century. International capital flows in recent years have also been relatively modest by comparison with earlier decades.

The extent to which New Zealand is able to benefit from this revolution in transport and communications depends importantly on government policies. Prior to the reforms of the mid-1980s, transport and communications in New Zealand were characterised by restrictions on competition, highly distorted prices to users and public sector provision of a wide range of services under conditions which provided weak incentives to reduce costs or meet consumer needs. Looking back, it is disgraceful that such an inefficient system could have been allowed to develop or to persist for so long.

The reforms in transport and communications since the early 1980s have been substantial. To list a few:

- The opening up of the domestic airline industry in 1987 resulted in a fall in the real price of airfares and an improvement in the quality and frequency of services for most passengers.

- The opening up of the telecommunications market and the privatisation of Telecom in 1990 resulted in large productivity improvements, substantial reductions in prices and improvements in services.

- The collapse of the trans-Tasman Accord, which had prevented international shipping lines from competing on the trans-Tasman route, has led to a fall of 50 percent in freight rates on that route since 1994.

- Port reforms since 1989, including the replacement of locally elected harbour boards with commercial port companies and greater competition in stevedoring, have resulted in a reduction of about 27 percent in the cost of moving a container through Auckland's Fergusson Container Terminal.

- The removal of restrictions on road and rail carriage in the early 1980s and the subsequent corporatisation (1990) and privatisation (1993) of rail has resulted in substantial improvements in the efficiency of both road and rail transport.

The list of transport sector reforms is impressive, but does not provide grounds for complacency. There are not many parts of the sector in which New Zealand stands out as being 'simply the best'. We like to think that New Zealand port reform is a success story, and there is no doubt that outstanding gains have been made. An international survey of waterfront charges by Australia's Productivity Commission indicates that in 1997 average costs per container were about 40 percent below those for Melbourne, the cheapest Australian port of the 15 ports covered in the survey. The difference between average costs for Auckland and those of the best performers in the survey, Port Klang and Singapore, were less than half the difference between Auckland and Melbourne.[8] This is quite an achievement because Port Klang and Singapore are among the world's biggest transhipment ports.

However, the New Zealand ports industry cannot afford to rest on its laurels. International shipping lines are moving to hub operations in order to avoid the costs involved in having large container ships stop at multiple ports. While this trend will further reduce transport costs, there is a risk that, rather than having a hub port of its own, New Zealand could be left out on the end of a spoke. Comments made by Geoff Vazey in May last year are relevant:

> Laughable as it might sound in the midst of the recent turmoil on the Australian waterfront, it's possible that a reformed and efficient Australian port could act as a South Pacific hub.
>
> Would you stake your business future on the hope that Australia will not get its act together, sooner or later?
>
> What this means for New Zealand is that we must maintain our drive for efficiency, we must look for the next stage of improvement in our management practices and structure. If we are not continuing to improve, we will inevitably begin to slide backwards.[9]

The idea that Australia might get its act together in this area does not now sound at all laughable. While there did not initially appear to be a clear winner in the dispute last year between Patrick Stevedores and the Maritime Union of Australia (MUA), there have been substantial improvements in productivity on the Australian waterfront, particularly in Melbourne, since the dispute ended. Greater competition may emerge on the Australian

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8 Productivity Commission, *International Benchmarking of the Australian Waterfront*, April, 1997, p 110.

9 G Vazey, 'New Zealand Ports – We Can Do Better Yet', address to shipping conference, Wellington, May, 1998.

waterfront in the years ahead with the large transport operator, Toll Holdings, attempting to extend its business on to the docks using non-MUA labour.

**Changes needed in the transport industry**

Most of the additional policy changes required to promote efficiency in New Zealand's transport sector can be summarised in one word – privatisation (or in the case of roads, corporatisation, at least as a first step). While this may still be regarded by some as a doctrinaire view, there are not many people anywhere in the world who are prepared to argue these days that government provision of goods and services is generally more efficient than private provision.

The main objection raised by opponents of privatisation is that private monopolies might arise and abuse their market power. Such problems clearly do not arise in the case of transport operators moving people or goods by sea, air, rail or road – which are already owned privately in any case. That leaves the provision of transport infrastructure, including ports, airports, airways services and roads, as areas of possible concern.

In the case of ports, the potential for a private owner to abuse market power is limited. There is substantial competition between many ports, such as between the ports of Auckland and Tauranga. Council owners of ports that are less exposed to competition, such as Westgate, may be more inclined to exploit market power than a private owner. The benefits of privatisation include:

- the potential for rationalisation. In the absence of privatisation there is no sure way of knowing whether the present number of ports in New Zealand represents the most efficient industry structure. Local government ownership impedes rationalisation;

- improvements in efficiency due to the introduction of private sector disciplines (especially through capital markets), better monitoring and less political interference;

- the elimination of commercial risks currently faced by ratepayers; and

- the opportunity for New Zealand port companies to participate in port industry developments offshore.

Private ownership of ports would hardly be a step into the unknown. Ports were privatised in the United Kingdom in the 1980s with beneficial results, and the Victorian state government has privatised two of its ports.[10]

The monopoly argument may be more relevant in the case of some airports. Nevertheless, there is significant competition between airports, between air and other modes of transport, and between services provided at airports and other retail centres. The sale of airports would involve Commerce Act 1986 scrutiny should a major airline or competing airport company seek to implement mergers or acquisitions. The privatisation of airports elsewhere in the world, including Australia, has introduced normal commercial disciplines and provided incentives for more efficient use of resources. Central government has substantially reduced its investments in airport companies, but the ineptitude of councils in determining their future involvement was highlighted by the fiasco over the sale of Wellington airport last year.

In the case of roads, the government's proposals in *Better Transport Better Roads* represent an important step toward a more commercially focused and efficient system of road transport.

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10 For a discussion of experience with the privatisation of ports in Britain, see R L Kerr, 'Paying for parochialism: The cost of stalled port reform', reprinted in *Excellence Isn't Optional*, New Zealand Business Roundtable, November, 1998.

The Minister for Transport has said, however, that as one of the "important safeguards to protect the interests of the public", roads would not be privatised.[11]

This decision puts fears of monopoly pricing ahead of fears that the wrong investment and pricing decisions will be made under government ownership (and also assumes without obvious justification that monopoly pricing would be more of a problem with privatisation than corporatisation). In technical language, it puts the risk of allocative inefficiency ahead of the risks of productive and dynamic efficiency. But where do we see the greatest potential benefits from road reform? Clearly, we want better investment decisions and better pricing. A benefit/cost ratio of 4:1 is telling economists that something is terribly wrong. Auckland and Wellington commuters confront this reality daily. But investment decisions also include maintenance decisions and the decision as to when and how to introduce direct billing technologies, and what type to purchase. Such investment decisions are fundamentally entrepreneurial. Local authorities have many competencies but being entrepreneurial is not one of them. Taxpayers watched central government being entrepreneurial with their money over Think Big. It was a $7 billion lesson. Similarly, price setting is entrepreneurial. Too high a price diverts demand and invites competitors to enter and expand. Too low a price loses money. Market prices can only be discovered spontaneously by market contest. There is no other objective way of finding the optimal price. Even assessments of future costs are subjective. Local authorities would be widely viewed in the business community as the sector with the least understanding of these matters. All too often they appear to see charges as a way of taxing businesses and non-ratepayers so as to buy votes from sympathetic voters.

In view of the fact that corporatised or privatised roads would need to compete for business with other roads, other modes of transport and different locational and lifestyle choices, monopoly problems should not be exaggerated. Monopoly problems would loom largest with central business district (CBD) roads. There are a number of options for reducing concerns about monopoly. They include light-handed regulation, franchising and tendered maintenance contracts for suburban and rural roads.

These observations do not purport to prove that privatisation is the best possible response. Instead their purpose is to explain why privatisation must be considered as a relevant option if politicians really do have the 'interests of the public' at heart.

Another argument that is sometimes made against privatisation of transport infrastructure is that it is a public good and would therefore not be supplied efficiently by private enterprise. The provision of pedestrian facilities is arguably a public good. However, like supermarket carparks, pedestrian facilities may be provided by private operators as a convenience for the travelling public. By the usual economic tests, motorised transport infrastructure is clearly not a public good. People who do not pay for access to the network, for example through car registration fees, can be denied access. Moreover, when the services of a particular part of the transport infrastructure are being used by one vehicle, it is not possible for it to be used by another vehicle at the same time. The fact that there is considerable excess capacity outside peak periods on most transport systems does not make them public goods. Excess capacity is common for many goods and services supplied by the private sector. For example, normal market incentives enable the private sector to supply cinemas and hotels even though they are not always full. The excess capacity associated with many rural and non-thoroughfare suburban roads may give such roads the attribute of a club good. Club goods can be supplied privately. Members of the club could tender road maintenance contracts and, if it is economic to do so, charge non-members extra.

The existence of externalities associated with transport facilities is another unconvincing argument against privatisation. It is true, for example, that the provision of new transport facilities can provide benefits which land owners and residents do not have to pay for, or

11 Maurice Williamson, 'Minister's Foreword', in *Better Transport Better Roads*, Wellington, 1998.

impose costs on them for which they are not compensated. But this occurs whether the transport facilities are privately or publicly owned. In many situations private ownership can even make it easier to internalise externalities by enabling the provision of transport infrastructure to be combined with property development.

These are all issues to be explored at length. No one should jump to hasty conclusions as to the optimal arrangements. Usage patterns and intensities vary widely across the roading network, technologies are developing rapidly, and public anxieties about pricing and monopoly must be recognised and satisfactorily addressed. If options like full privatisation are not put on the table for discussion, their merits are unlikely to be fully recognised and suspicion and fear about 'hidden agendas' are likely to distort debate and jeopardise promising options.

**Conclusion**

New Zealand has been taking yet another long teabreak in recent years while many other countries have been making greater efforts to improve the performance of their economies. Our gross domestic product per capita continues to slide relative to many other countries, and in the past two years there has been a renewed outflow of young and skilled people. If New Zealand is to achieve its economic growth potential and close the productivity gap with leading countries it will have to adopt superior economic policies.

This means we must strive to improve our public policies by every possible means, including in the transport sector. We have lost opportunities for participation in the Australian ports industry and further afield because our innovative port companies have been shackled by the constraints of public ownership. We may lose out on being a regional transport hub if we do not make further progress soon with privatisation and rationalisation of the ports industry.

Other countries are not standing still. Australia now has a major publicly listed roading company and several large private sector roading ventures. South Africa is putting roading on to a commercial basis and Argentina has privatised many of its roads. Similar developments are occurring in many other countries. In the case of roads, ports and airports, local government is the main obstacle to change, and central government will need to step in and direct reform if faster progress is to be made.

Finding better ways to use resources is the basis of improvements in living standards. The transport sector accounts for a large share of national resources, and a failure to make all achievable improvements in this sector will hold the whole country back. The costs of inertia in recent years are showing up in many economic indicators – a weaker growth rate, rising unemployment and a large current account deficit. Restoring the earlier momentum of change in the transport sector and elsewhere in the economy should be an urgent national priority.

NEW ZEALAND BAR ASSOCIATION CONFERENCE

# IS THE LAW A PROFESSION OR A BUSINESS?

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

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# IS THE LAW A PROFESSION OR A BUSINESS?

I believe that I am a member of a rare species – a non-lawyer who defends the role of lawyers. This springs from a belief that the core function of government is to maintain the rule of law, and for that we need lawyers. I also wish that governments would concentrate on performing their core functions well instead of scattering their efforts over too many functions and ending up performing many of them badly, including administering justice and enforcing the law.

But what is this vital role that we are talking about? The title of this session suggests a false dichotomy based on a jaundiced view of the conduct of business. It also, unfortunately, conveys an air of moral superiority which is not warranted.

The last 200 years have seen an unprecedented rise in material income for a large part of the world's population. This has been accompanied by increases in longevity and general health. These advances have been primarily due to the activities of business people. The professions' role in this process (even the medical profession's) has been less important and sometimes downright obstructive.

However, it is also true that these achievements have only been possible where there is a legal system based on respect for individual freedom and property rights. For business and innovation to flourish, people must be free to follow their own ideas and confident that they will be able to reap the rewards for their efforts. It is no accident that this process of massive wealth generation began in the eighteenth century in the only country (England) in which those conditions applied.

We all have a stake, therefore, in the effective, impartial and predictable operation of the legal system. Every legal dispute and every legal transaction affects interests other than those of the parties. It is thus right and proper that the structure and regulation of the legal profession should be a matter of public debate, and it is vital that public debate is well-informed.

Against this background, and as part of its general interest in occupational regulation, the New Zealand Business Roundtable has commissioned a study of the regulation of the legal profession which be published early in 2000.

This supposed dichotomy between business and the professions is also false for another very simple reason. The legal profession has to operate in a business-like fashion. Legal practices must employ staff, purchase supplies and lease premises, and conduct all these relationships in a business-like way. And the object of a legal practice, even that of a barrister or a Queen's Counsel (QC), is to make a profit by providing a service that clients want. There is no conceptual difference between the net earnings of a sole legal practitioner and those of the largest commercial corporation.

Structural changes to the profession in recent decades have made legal practices look more like other types of business. Legal and accounting firms are now among the membership of the Business Roundtable and its Australian counterpart, the Business Council. Today, a third of the legal profession are members of firms with 10 or more practitioners. At about that point, the effectiveness of informal monitoring and the importance of peer approval start to fall off, the risks of free riding and shirking start to increase and, inevitably, there is a greater focus on formal monitoring and financial incentives. So it is impossible to conceive of the legal profession not adopting many of the attributes of business.

However, it is not enough to bandy about labels, like 'profession' and 'business'. The real question from a public policy perspective is what is the optimal regulatory framework which should apply to the market for legal services. The objective should be to maximise the satisfaction of consumers of the system at the lowest possible cost in terms of resources used. The system should provide incentives which encourage individuals and firms to take decisions in their own interests which also promote the interests of the community at large.

It would hardly be surprising if the current regulatory system were not optimal. A single system is supposed to deal on the one hand with the ethics and standards of a large number of small practitioners and on the other hand be capable of investigating the conduct of large, well-resourced firms involved in complex international transactions. The choice we are faced with is not between 'regulation and ethics' and 'no regulation or ethics'. The choice is between specific statutory monopoly regulation and something more akin to the operating environment of other professions and industries which often form voluntary associations and enforce their own rules subject, of course, to the general law of the land.

I suspect that there are really two concerns behind the thinking that the practice of law is not essentially a business activity.

One is the prospect that the profession will be deregulated. But those who talk about law being a profession as if this self-evidently justifies specific statutory regulation paint a false picture of a deregulated environment. For a start, a 'deregulated' profession would be subject to the general law of fraud, the Consumer Guarantees Act 1993 and so forth. And every time greater competition is proposed in a new area, there seems to be a host of people who forget that when greater competition has been introduced in other areas costs have typically fallen and the quality of service has risen. The Australian National Competition Council has reported that conveyancy fees in New South Wales fell by 17 percent after the abolition of the legal profession's monopoly in 1993, and the Trade Practices Commission has found that most errors in conveyancy in South Australia have been in work done by solicitors, not conveyancers. As a general proposition the so-called 'race to the bottom' is a myth.

The second concern is that the concept of a 'profession' reflects a body of ideals upheld by practitioners. These ideals go beyond winning the current case, or takeover battle, and reflect the interest we all have in an effective and predictable legal system. These ideals are summed up by the litigator's concept that they are an officer of the Court and that this duty comes before one's duty to one's client. But it is equally important that the transactional lawyer can be confident that the other side's representatives will answer questions truthfully.

So those who talk of the 'profession of law' are often concerned that these standards have been eroded, and could be eroded further by deregulation. They are rightly conscious of the fact that institutions such as the Courts and the Land Registry are among the 'customers' of the legal profession. Their procedures would have to change and would become more expensive if they cannot rely on minimum standards of integrity and competence on the part of lawyers. The undoubted public interest in the maintenance of these standards forms one of the lines of argument in favour of some form of regulation of the legal profession. The other line of argument relates to consumer protection.

People go to lawyers for advice on major decisions which affect their own and their family's livelihoods. In order to get good advice, clients must be willing to entrust their lawyers with confidential information, information that in the wrong hands might be damaging. It is also true that clients often do not have much information with which to compare the abilities of different lawyers or law firms, but nor do consumers of all manner of goods and services in a sophisticated modern economy.

Suppliers of complex services therefore use a variety of devices, such as branding, warranties, and investment in reputation, to assure consumers of their integrity and quality. So we see lawyers binding themselves not to reveal clients' confidential information, not to make use of such information for their own profit, and not to act for another party to the same transaction, at least not without informed consent. They also have to give some assurance of quality control. Without these assurances, clients would not appear. The same is true of bank managers, financial planners and many other advisory services.

Business people also, by and large, want accurate advice about what is likely to happen in a dispute. They do not want to be told just the story they want to hear. No one wants to be drawn into litigation that they cannot win, unless they are making some political point. Obviously, there are instances of 'opinion shopping' and pressure to produce a particular opinion, but this is a feature of all professions and all regulatory environments.

So it is interesting to imagine, as a thought experiment, what would happen if we simply repealed the Law Practitioners Act 1982.

Lawyers would continue to be concerned to protect their reputations and to ensure that they could trade on those reputations. Provided the benefits exceeded the costs, they would form one or more voluntary societies to advance their common interests. These societies might adopt codes of ethics enforced by disciplinary procedures, and might advertise themselves accordingly. Bearing in mind that the six largest law firms in New Zealand are each larger than several of our current district law societies, some lawyers might choose not to join a professional association but to rely on the interest their firm had in maintaining a strong brand. Firms would be at least as interested as the profession as a whole to create, maintain and trade on a reputation. Some lawyers might decide that the benefits of joining a professional body were not worth the costs.

As long as barriers to the creation and dismantling of voluntary associations were low, the pressure of actual or potential competition would cause them to offer the level of protection for clients that clients actually wanted. A diversity of arrangements might be expected to emerge.

Likewise, if there were a group of self-employed barristers who had a rule that they could only be instructed by solicitors, or other professionals, and these people were given business, it would be clear that the rule was perceived by clients to be in their own interests.

Now contrast that with the current situation.

We have a monopoly regulator, the New Zealand Law Society. District law societies are also local monopolies of a kind which have rules carving up the market between them. The level of regulation is partly laid down in the Law Practitioners Act 1982 which covers, for example, the solicitors' monopoly over conveyancing, and partly in the Rules of Professional Conduct. The New Zealand Law Practitioners Disciplinary Tribunal and the Council of Legal Education are in form independent statutory bodies, but they look very like off-shoots of the New Zealand Law Society.

This structure has a number of disadvantages for lawyers and particularly for the way lawyers are perceived.

Because we have a monopoly regulator, there is little incentive to find the optimal level of regulation. The suspicion is bound to be created that the Law Society pursues and protects the interests of lawyers, not clients. So, for example, the rule that one can only approach a barrister through a solicitor looks like a restrictive practice, and as long as there is monopoly regulation it is very hard to persuade anyone otherwise.

Conversely, the fact that the Law Society is a statutory monopoly means that it has weak incentives for effective performance in representing the interests of its members. To many lawyers, the Law Society is just an address to which they have to send an annual cheque in order to practise their chosen profession. The large firms constitute over a sixth of the profession, but are routinely under-represented in the institutions of the Law Society and at its conferences and events. The very existence of those large firms may indicate that there is market demand for stronger branding than the Law Society can itself provide.

The Law Society's monopoly status also means that its processes are subject to the vagaries of judicial review and that it imposes on itself high standards of proof before it will take disciplinary action against a member. The maintenance of standards thus becomes difficult and expensive.

These outcomes are not simply due to the fact that the Law Society is the representative body as well as the regulator. It is the inevitable consequence of having a monopoly regulator. When there is scope for competing voluntary associations, an association would be less likely to pursue the interests of members rather than clients, or of the leadership rather than the membership, as it would simply lose members to other associations. And as long as the Law Society continues as the monopoly regulator, as its president proposes, the Law Society will be able to reach all lawyers in a way that the voluntary representative bodies envisaged by the president would not be able to do. They will then find it impossible to compete with the Law Society in a number of areas, such as continuation training and publications.

Nor is there any incentive for the Law Society even to find the optimal structure for regulation. At present the legislation insists on geographically defined local law societies. Under a less regulated regime I suspect that that structure might continue for rural and even urban general practitioners, but the success of the various sections of the Law Society implies that many urban lawyers would rather be members of groups defined by specialism not geography. But I do not know for sure and, indeed, it is the merit of a less regulated system that we do not have to go through an exercise like the E-DEC Report commissioned by the Law Society and the debates that followed it. Nor would the Commerce Commission need to examine professional rules. The best structures would sort themselves out and, furthermore, change in response to changing circumstances.

Statutory monopoly regulation can also have the effect of gulling the public into believing that they do not need to enquire into the standards of the lawyers they are dealing with. But 1,400 practitioners, 20 percent of the profession, are in practices which have only one, two or three practitioners. Apart from barristers in sets of chambers, such practitioners face little or no peer pressure to maintain standards. It is very difficult for the Law Society to supervise such a large number of lawyers scattered over the whole country, partly because the only control is the expensive and cumbersome statutory disciplinary procedure which requires a high standard of proof. And it is in these kind of firms that the majority of problems involving clients' funds arise, not to mention issues of competence and professional ethics.

So the fact is that it is probably the sector of the legal market patronised by the least sophisticated clients that is least effectively protected by the current monopoly. The current system cannot be defended on the ground that it is necessary to control such practitioners and protect unsophisticated clients: it is clearly not doing the job adequately. On the other hand, arguments about consumer protection do not really apply to sophisticated commercial clients, nor to lawyers who mainly advise other lawyers.

In fact, few professions can have such a varied clientele. Not only is the pool of potential clients the entire population of New Zealand, and one cannot get more varied than that, but each of us may need legal services in a variety of capacities – parent, tenant, landlord, taxpayer, employee, entrepreneur, accident victim and so forth. Some transactions require a Rolls-Royce service to insure against error when dealing with large sums of money, while others require off-the-peg services at a lower cost. Some lawyers are involved in advising on structures and transactions, others are wholly devoted to litigation. With business clients, the work of lawyers often merges into that of accountants, management consultants and human resource managers.

It seems unlikely, then, that a highly restricted industry structure will fit all these diverse working styles. About the only thing that one can state with confidence is that no one knows enough to know what the optimal structure and organisation of the legal profession is.

In that case, the correct strategy is surely to encourage institutional arrangements which are flexible enough to cope, not only with diversity, but with needs that change over time. The only way to do this is to ensure that professional associations have the incentive to respond to differing needs and to changing requirements. This requires scope for a variety of voluntary and competing associations. The potential for competition between those associations would stimulate them to ensure that they were pursuing clients' interests.

Competition between professional associations is also vital to ensure innovation. Take, just as one example, the fidelity fund and the Law Society's audit system. Is this, today, the most efficient and effective way of ensuring that clients' money is safeguarded? Risk-rated insurance might be more efficient and effective, or that approach might be better for some circumstances and the existing approach for others. At present lengthy argument is required before a change from one system to the other can be agreed on, and the consent of the government is still needed. Much better to allow voluntary bodies to choose to offer either system, some other arrangement or none at all, and to see which works better for whom.

Under a system of voluntary associations, clients would continue to select lawyers in much the same way as they do today, which is mainly referral by word of mouth. If that is insufficient, there are plenty of other mechanisms for informing clients about the quality and price of legal services, including the work of consumer organisations. An important indicator of the level of service is price, so one person might take, say, an employment problem to a large Wellington or Auckland legal firm and another might go elsewhere, both being guided primarily by price as the indicator of the level and standard of service.

It should be obvious then, that the current statutory monopoly is not the only way of skinning this particular cat. This is not to argue that total deregulation – simple repeal of the Law Practitioners Act 1982 – is the only or best alternative either. I described that idea as a 'thought experiment' – I can see many ways in which a deregulated law profession could adapt and improve many of its services in an environment similar to that of other deregulated professions and industries, but it is not my position that this is all that needs to be done. Many issues need to be worked through to determine which, if any, pieces of specific regulation should be retained. All I am saying is that it is not enough to point out a problem that some measure of deregulation and greater exposure to the ordinary forces of the market allegedly cannot deal with. Any criticism of a deregulatory approach must compare reform proposals either with current reality or with some competing practical proposal, recognising that there is no perfect system.

There are practical alternatives. One is the large measure of deregulation that has been implemented in the accountancy profession, the closest relation to law in the professional family. This happened with a large measure of consensus within the profession and seems to be regarded as a thoroughgoing success.

For law, we need only look as far as Victoria, Australia to see another model in action. Victoria has legislated a 'light-handed' regulatory system for the legal profession. Lawyers must be licensed by a Recognised Professional Association (RPA). RPAs in turn must be accredited by the Legal Practice Board. At present there are only two RPAs, descended from the old Law Institute (the solicitors) and the Victorian Bar, but there is no barrier to others arising.

In fact the Victorian legislation is relatively conservative. There may be no need to require membership of an RPA since, as I have argued, it is in lawyers' interests to belong to effective professional associations or major firms and to advertise the fact. Victoria retains a fidelity fund, whereas in New Zealand we have already debated getting rid of such an institution, and the then minister of justice decided that it should be retained for reasons that were not easy to understand.

We should also avoid corralling off the legal profession from others and stifling innovative and multi-disciplinary approaches to problems. Rather than seeing huge firms develop whose only real unity is that they offer services that can only be offered by lawyers, we might see niche firms arise which deal with particular types of transaction from all angles: legal, accounting, investment, management advice and so forth. We cannot know that the current structures are the best way of doing things as long as they are ossified and protected by legal and professional regulation.

This discussion is not about eroding professional or even traditional standards. All judges were once lawyers, so the last thing any of us would wish to see is the erosion of those standards. Indeed, it is far from clear that the current system has succeeded in maintaining respect for the rule of law and the impartial and impersonal administration of justice. And the current system certainly cannot guarantee to protect those standards in the most efficient and effective manner, for the very simple reason that, as long as there is a monopoly regulator, no one can have any idea whether the current structures are the best possible. And that is the standard we should be aiming at.

AIC 7TH ANNUAL NEW ZEALAND WATER SUMMIT

# WATER REFORM IMPERATIVES

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# WATER REFORM IMPERATIVES

## 1 Introduction

Water industry reform is one of many areas in which New Zealand has fallen dramatically off the pace in recent years. The industry ranks with other utilities like telecommunications, electricity, gas and roading in terms of its contribution to the economy, to the living standards of New Zealanders, and to the international competitiveness of the business sector. The faltering progress in microeconomic reform since 1993 is costing New Zealand dearly in terms of deteriorating growth rates and rising unemployment.

The direction New Zealand must take in reforming the water industry is clear. Political involvement in, and control of, the industry must be replaced by greater reliance on market mechanisms. This approach has led to impressive gains in other utility industries. Market-oriented reforms have substantially improved the performance of overseas water industries and there is the same potential for improvement in New Zealand.

A market-oriented reform package would include the following elements:

- introducing efficient pricing for water and wastewater services at least in most towns and cities;

- improving the incentives for performance of the local government-owned water and wastewater businesses through corporatisation;

- privatising the water and wastewater businesses as a likely subsequent step to overcome the deficiencies inherent in the corporatisation model;

- making greater use of franchising and contracting-out if there is a strong political preference to retain public ownership;

- removing the special restrictions in the Local Government Act 1974 which prevent Watercare Services Limited operating in a fully commercial and accountable manner; and

- addressing any market power problems through a light-handed regulatory regime relying on the Commerce Act 1986 and information disclosure requirements.

These recommendations were made in the report *Reform of the Water Industry* prepared for the New Zealand Business Roundtable by CS First Boston in 1995. The fact that little has changed four years down the track, despite a degree of acceptance of their general thrust, is a sorry reflection on the inertia and entrenched ideologies in local government.

This paper reviews the minimal reform that has been achieved in New Zealand in the water industry and contrasts this with the achievements of other countries.

It then discusses why a more market-oriented approach, including changes to governance and pricing arrangements, is likely to yield substantial improvements. Although these arguments should be well understood by now, the glacial speed with which councils are implementing change suggests they need restating. The case for adopting a light-handed regulatory regime as the best option for controlling the market power of water and wastewater businesses is briefly recapitulated.

Finally, the case for rationalising the water industry is considered. The current structure of the industry has been determined politically, based on local authority boundaries. It is unlikely to be optimal. The difficult issue is determining what a better arrangement might look like.

## 2 Reform of the water industry

### 2.1 'Reform' in New Zealand

A review of progress to date in the reform of the water industry in New Zealand makes pathetic reading. Although many councils appear to have considered reform options, few have made substantial changes.

Auckland City Council is the only council to have formed its water business into a Local Authority Trading Enterprise (LATE), having established Metrowater in 1997. The Council had second thoughts about this sensible change soon after. Metrowater has so far survived, but only just. It is already delivering improvements in performance and cost savings. In its first year of operation Metrowater reduced water losses from 17 to 13 percent; achieved an A grading for water supply across Auckland City for the first time; and produced the first ever long-term management plan for its assets. User charges have reduced the rate of increase in water consumption compared with the rest of Auckland.[1]

Papakura franchised its water and wastewater operations to United Water in 1997 under a 30-year agreement, the first of its type in New Zealand. Papakura's supply is managed by a company that is focused on water and wastewater services and which can draw on the technical expertise of its worldwide operations. The franchise arrangement has achieved net cost savings of 10 percent, which have been passed on to ratepayers. Papakura's record shows that, with political will and leadership, substantial benefits can be delivered to ratepayers. Franchising has also been used, or is being contemplated, for a few greenfield developments such as Wellington's sewage treatment plant.

Councils have increasingly used contracting-out options. Capital construction and maintenance works are frequently contracted to the private sector. Reticulation operation is also occasionally contracted out. A number of councils have formed their construction and maintenance operations into LATEs or business units, and require them to tender for work in competition with the private sector. Savings of 10 to 20 percent from contracting out are commonly cited.[2]

Asset management is also improving, although at the end of 1997 considerably fewer than half the councils responding to a Department of Internal Affairs survey had asset management plans in place for their water and wastewater assets.[3] Better monitoring of the condition of assets has revealed that a large number of councils face major upgrading of their water supply and wastewater infrastructure. The Auckland City Council recently stated that rates would have to rise between 13 and 15 percent to fund failing stormwater pipes. These figures seem dubious, but the fact that action on run-down systems is only now being taken years after such problems were recognised speaks volumes about the inadequacy of local government control. Remedial works around the country are likely to have a substantial impact on service charges.

Little progress has been made to introduce more efficient prices. Metering has been extended only in a very limited way in some cities. Wellington, for example, has adopted a voluntary metering regime. It also introduced a fixed charge per household, which was a

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1 A press release of 10 September, 1998 noted these and other gains achieved by Metrowater in its first year of operation.

2 See, for example, CS First Boston (1995), *Reform of the Water Industry*, report prepared for the New Zealand Business Roundtable, p 126.

3 'Review of the Powers and Responsibilities of Local Authorities to Provide Water and Wastewater Services: Overview of Analysis of Returns from a Survey of Local Authorities', Bridgeport Group, April, 1988, pp 8 and 13.

move towards more efficient pricing, but contemplated reversing that decision a year later. The most woeful case is Christchurch which has a wide base of installed water meters but has never used them.

Many councils do not charge for the water used, or base their charges on the cost of supplying the service. Over-consumption has harmful environmental as well as economic effects, but environmental organisations seldom support the most obvious solutions. Prices commonly do not include the full opportunity cost of capital. Pricing is still strongly influenced by politics. Garry Moore, the mayor of Christchurch, has vowed to fight "like a mad dog" against plans to introduce a user pays system for water and sewerage services.[4] One might ask why he is not also fighting "like a mad dog" against user charges for electricity, telecommunications, food, clothing and many other goods and services which are far more costly items in household budgets. Perhaps he has been too exposed to the abundant midday sun this summer. This resistance to efficient pricing principles that would wisely ration scarce resources epitomises the blinkered ideology of councils like Christchurch.

In the last four years no rationalisation of water businesses has occurred despite the large number of local authorities involved in provision. Even in Auckland and Wellington where expensive studies of rationalisation options have been completed, nothing has been achieved.

The government has tinkered with Watercare, but only in an ineffectual way. The 'club' ownership arrangement, in which local authorities are both customers and shareholders, will prove problematic. Their interests as shareholders and customers will conflict, pricing and investment are likely to politicised, and the monitoring and performance disciplines associated with political control will be weak. Legislative restrictions, such as the restriction on local authorities selling their shares and the constraint on Watercare paying a dividend, will continue to undermine its ability to operate in a fully commercial and accountable manner.

The dismal saga is an indictment of local authority control. Local government politicians have not been prepared to lead opinion and sell the benefits of reform. Instead they have generally chosen to pander to misinformed concerns about change. In my view, central government must step in and direct reform, as it has with roading. Its current review is welcome and provides an opportunity for progress at last.

### 2.2 Reform overseas

The slow progress in New Zealand stands in stark and sorry contrast to the achievements in other countries where commercialisation and private sector involvement have become increasingly the norm.

In Australia, most of the water and wastewater industry has been corporatised. The Hunter Water Board was corporatised in 1992. The Sydney Water Board was corporatised in 1995. The largest Western Australian water utility was corporatised in 1996. The major water utility in South Australia, the South Australian Water Corporation, was corporatised in 1995. Melbourne Water was corporatised in 1991 and then restructured in 1995.

Around A$5 billion worth of water, stormwater and wastewater projects has been contracted to the private sector in Australia, with a further A$10 billion likely to be offered for private tender over the next five to 10 years.[5] Following corporatisation, the South Australian Water Corporation franchised all water supply and sewerage services in the Adelaide metropolitan area to a private company, United Water, for 15 years. The

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4 *City Weekly*, 25 January, 1999, p 3.
5 *Australian Financial Review*, 18 August, 1998, p 33.

franchising arrangement achieved cost savings of around A$10 million per annum.[6] The ACT government has been endeavouring to secure support for privatisation of its electricity and water utility.

Other reforms have also been implemented. The Hunter Water Board began a process of demand management through user pays price reforms as early as 1982. The Sydney Water Board moved from property-based charges to usage charges during 1995 and 1996. Rural councils have also moved towards usage-based water pricing. The New South Wales government introduced tradeable water permits in 1988.[7] Similar moves have occurred in other Australian states.

Some of the gains achieved in Victoria illustrate the benefits that New Zealand is forgoing by its lack of action:

- the metropolitan industry is on track to delivering cost savings of around A$150 million over the five years since restructuring in 1995. At the same time, service standards have generally improved;

- the non-metropolitan urban water authorities reduced their operating costs by 17 percent between 1994/95 and 1996/97 while substantially improving their technical and commercial performance; and

- the annual gains from water trading have been estimated to reach A$50 million per annum by the year 2000.[8]

Market-oriented reforms have been implemented in many other countries as well. Scotland amalgamated its water and wastewater service supplies into three entities which were corporatised in 1996. The reforms in England involved corporatisation prior to privatisation.

Chile has established 13 corporatised water and sanitation utilities. The largest utility, EMOS, serves a population of five million in the Santiago metropolitan area. A World Bank study notes that EMOS performs well in terms of standard indicators of utility performance.[9] At the same time that EMOS reduced tariffs by 26 percent it achieved improvements in service levels.[10] Chile is pushing ahead with plans to sell shares in its water utilities.[11]

The increasing involvement of the private sector in the water industry, particularly in third world countries, is also remarkable. A World Bank report notes that before 1990 almost all developing countries relied on government provision of water supply and sewerage services and that private participation was rare.[12] Between 1984 and 1990 developing countries awarded contracts to private companies for only eight water and sewerage projects to a value of US$297 million.

Private participation has accelerated since 1990. Between 1990 and 1997, a total of 97 projects were implemented in 35 developing countries, with projects ranging from

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6 *ibid*, p 37.

7 Australian Industry Commission, *Microeconomic Reforms in Australia: A Compendium from the 1970s to 1997*, Research Paper, AGPS, Canberra, January, 1998, pp 75–76.

8 Clarke, R, *Implementation of COAG Reforms: Approaches and Issues*, paper presented to AIC Australian water conference, 23–24 June, 1998, p 6.

9 Scott, G and Brook Cowen, P, 'Some Issues in Institutional Reform for Improved Performance in Government-Owned Water Utilities', draft report for the World Bank, 1996, p 29.

10 Brook Cowen, PJ, *Utility Reform and Private Sector Participation in the Water and Wastewater Sector: An International Perspective*, AIC 6th Annual NZ Water Summit, 26 February, 1998, p 7.

11 *The Press*, 26 August, 1998.

12 Silva, G, Tynan, N and Yilmaz, Y, 'Private Participation in the Water and Sewerage Sector – Recent Trends', *Viewpoint*, World Bank Group, August, 1998.

management contracts to leases, concessions, divestitures and greenfield build-own-operate or build-operate-transfer arrangements. Concessions were the dominant form of private sector involvement, with divestiture being relatively rare. The total value of the investment projects with private sector involvement in the period 1990–97 was nearly US$25 billion.

Penelope Brook Cowen, an infrastructure expert at the World Bank, commented at last year's AIC water conference that "private sector participation does appear to yield significant improvements in utility performance; and the gains are more unambiguous the more responsibilities are passed to the private sector ... ".[13]

## 3 Key elements of a market-oriented approach

This section looks at some of the key elements of a market-oriented approach to reform of the water industry. It considers governance, pricing and regulation of market power.

### 3.1 Changes to governance

Different governance arrangements impose different incentives and constraints on individuals. Changes to the incentives and constraints that individuals face will affect their performance. The aim should be to encourage managers and staff in water businesses to act in ways that are more consistent with the interests of consumers and ratepayer-owners.

Governance arrangements in the water industry range from council departments, council business units, LATEs and contractual arrangements with the private sector, to outright private ownership. They impose different constraints and incentives on individuals, resulting in systematic differences in performance.

Managers of council departments face conflicts because of the multiple roles and objectives of councils. A council has an ownership role in relation to its water and wastewater assets. It determines what services are to be provided to customers, and usually provides the services. The council has a role in representing customers, who usually do not have a direct relationship with the service supplier. The council effectively regulates the charges that are levied on customers. It also has regulatory responsibilities under the Local Government, Resource Management, Building and Health Acts. Even if these responsibilities are separated from service provision within councils, conflicts arise at the chief executive and council levels.

The roles and objectives of councils translate into multiple roles for the managers of council departments. With multiple objectives, managers must make trade-offs between them, often without guidance as to their relative importance. Monitoring of performance is more difficult. And because performance is more difficult to measure, the incentives for performance are weakened.

Without a direct relationship between a council department and its customers, the service supplier has limited information on consumers' preferences. The lack of contact reduces the incentive of the supplier to be responsive to customers' interests. Council involvement politicises price setting, with the result that prices are often set too low, leading to excessive demand for water.

Council business units have a greater commercial focus but are rarely given a single commercial objective. The problem of multiple objectives remains. Political and commercial roles are not separated since business units remain divisions of councils. Often business units do not have their own balance sheet or accounts. Price setting is still strongly influenced by political considerations.

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13 Brook Cowen, P J, *op cit*, p 6.

The problems associated with council departments and business units can be ameliorated by extensive contracting out of services. Competitive tendering of contracts to the private sector for capital expenditure projects, maintenance and operation of assets is a powerful way of minimising the costs of providing water and wastewater services. However, contracting out does not ensure that the council department or unit makes investment decisions at the right time and chooses the right level of capital expenditure or maintenance – it only increases the likelihood that the level chosen will be delivered relatively efficiently.

Corporatisation gives managers the primary objective of profit maximisation, subject to regulatory constraints on monopoly power. A profit-maximisation objective provides a clear focus for managers. It facilitates monitoring of management performance by owners and customers and motivates the business to strive for efficiency. Consumers benefit because corporatised firms have strong incentives to determine customer preferences and to satisfy them at minimum cost.

The main problem with the corporatisation model is that, over time, governments find it difficult to maintain an arm's length relationship with the organisation. Interference by politicians in decision-making weakens incentives for good performance. This is one of the main reasons why privatisation is ultimately the preferred option. Privatisation can cement in the gains from corporatisation while strengthening incentives for performance by exposing managers to capital market constraints.

If there is a strong political preference for retaining public ownership, greater use of contracting out and franchising may achieve improvements in efficiency, particularly in the short term. However, franchising requires detailed input from a buyer in contract design and performance monitoring. It does not therefore necessarily overcome incentive problems associated with government involvement.

In my view corporatisation of major urban water and wastewater businesses would deliver substantial benefits. Metrowater's experience as a corporatised entity confirms this, as does overseas experience. Privatisation would maintain these benefits and yield additional gains.

For smaller water and wastewater operations the overheads associated with LATEs may outweigh the benefits of an increased commercial focus. One solution would be for smaller operations to amalgamate into larger entities to economise on the overhead costs of establishing LATEs. Another option would be for them to remain (or become) business units but to contract out all of their capital and maintenance work, as well as operating services. The business units would then have primary responsibility for managing contracts with private providers.

### 3.2 Reform of pricing

Reform of governance arrangements goes hand-in-hand with improvements to pricing arrangements.

Water utilities must move towards use-related charges. Prices should be based on the opportunity costs of supply to ensure that users take proper account of the true economic costs of water and sewerage services. Efficient prices for water and sewerage services should include the value of water in alternative uses, the costs of any environmental damage, the cost of operating and maintaining the system, the opportunity cost of capital and the capital costs brought forward by demand. Fixed charges should be used to cover fixed costs if marginal-cost pricing does not generate enough revenue to cover total costs.

Efficient pricing requires metering of usage or the adoption of a proxy for usage. It is possible that the benefits of user charges will currently be outweighed in some supply areas by the costs of installing and monitoring meters for some customers. However, these situations are likely to become more limited as demand for water grows, and supply can only be increased at an escalating cost.

### 3.3 Regulation of market power

The regulatory environment needs to be considered when businesses are corporatised and a commercial approach to pricing is adopted. A profit-maximising objective gives corporatised entities incentives to exploit any market power they may have.

The Business Roundtable remains of the view that a light-handed regulatory regime involving information disclosure and the provisions of the Commerce Act 1986 offers the best option for regulating corporatised and privately owned water and wastewater businesses. It imposes constraints on market power while retaining incentives for managers to optimise the efficiency of their organisations and minimise costs. The regime is not perfect – there may still be some abuses of market power – but the alternatives are worse. While a heavier-handed regime may impose stronger constraints on the exploitation of market power, it simultaneously undermines the incentives to minimise costs and optimise investment. The costs of the distortions to productive efficiency are likely to far outweigh the costs of any monopoly pricing.

Concerns about monopoly are not an obstacle to privatisation. The same issues arise with corporatisation, and indeed with other forms of public ownership. Research suggests that public ownership is an inferior strategy for controlling monopoly compared with light-handed regulation that relies on sound competition statutes, especially given the other disadvantages of public ownership.[14]

## 4 Industry structure

The structure of the water industry has largely been determined by political considerations (the boundaries of the local authorities) rather than commercial forces. This suggests that the current structure is unlikely to be optimal. This conclusion is reinforced by the observation that there are a large number of entities serving a relatively small population. Seventy-three local authorities, Watercare and the Wellington Regional Council provide water and wastewater services, with around a third serving populations of fewer than 20,000 people. The World Bank has suggested that the minimum efficient scale of water industry firms may involve a population base of around 500,000.

Although it is likely that there would be efficiency benefits from rationalisation there is no straightforward way of determining what form rationalisation should take, what entities should be rationalised, and how rationalisation should be initiated.

It is nearly impossible to centrally plan an industry efficiently – to determine the optimal number of entities, and preferred contractual arrangements. The problem could be solved by privatising the water and wastewater businesses and allowing private operators to seek out rationalisation opportunities within the constraints imposed by the Commerce Act 1986. Alternatively, councils could be required to franchise their operations at the same time, which would allow private firms to bid for groups of contracts, subject to the same constraints. A further major potential advantage of privatisation options is that it would allow the development of multi-utility businesses where synergies between the supply of water and sewerage services and electricity, gas, telecommunications or roading services may exist.

Corporatisation could also improve the incentives of water and wastewater businesses to search out rationalisation opportunities. However, compromised versions of the

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14 See Willig, Robert D, 'Public versus regulated private enterprise', *World Bank Research Observer* (Annual Conference on Development Economics Supplement), 1993, pp 155–180.

corporatisation model and the desire of councils to retain control of local businesses may undermine these incentives.

Corporatisation may also not be a feasible option for some of the smaller entities – for such entities amalgamation or other contracting options would need to occur before consideration was given to corporatisation. However, the studies undertaken in Auckland and Wellington found that substantial efficiency gains could be achieved through amalgamation in these centres. Many of the benefits could potentially also be achieved through contractual arrangements. In France, for example, the water and wastewater assets owned by 36,000 communes are for the most part operated by three private companies through franchise arrangements.

I strongly doubt that local authorities will achieve any significant rationalisation of their businesses unless they are required to do so by central government. The government needs to devise a process to require councils to consider options for rationalisation and to implement them if potential efficiency gains are demonstrated.

Given the likely gains from corporatisation of relatively large water and wastewater businesses, the government could mandate the formation of LATEs in major urban areas. It could require that, during the establishment phase, establishment boards consider the scope for realising efficiency gains through amalgamations or other contractual arrangements. Establishment boards could be required to report on the options considered and the reasons why a particular course of action was chosen.

Smaller utilities could be given the choice of amalgamating with other utilities to form LATEs, or contracting out most or all of their operations.

## 5 Conclusions

The fact that so little progress has been made on reform of the water industry in New Zealand in recent years reflects deep-seated problems in local government. These include weak incentives and accountability, vulnerability to special-interest lobbying, the poor quality of analysis by many council managements, councillors with a poor understanding of public policy issues, and overly-politicised, factionalised councils. In a highly politicised climate it is not surprising that inertia and resistance to change win the day so frequently. But paralysis is neither good enough nor inevitable. The general lack of progress made by most local authorities over the past four or so years contrasts with the changes achieved in Papakura, most Australian states and many other countries.

The introduction of a market-oriented approach to reform would yield substantial improvements in efficiency. Corporatisation and greater use of franchising and contracting out would improve the incentives for performance of the local government-owned water and wastewater businesses. Privatisation would overcome the problems inherent in continuing government ownership.

The adoption of more efficient pricing arrangements must be part of a more commercial approach.

Regulation of market power in the water industry should be by way of a light-handed regime. This approach has been outstandingly successful in New Zealand, bringing benefits that far outweigh any detriments. Heavier-handed regulation would impose substantial costs in the water industry and other utilities.

Rationalisation of the water industry is likely to yield efficiency gains. However, determining what form rationalisation should take, what entities should be rationalised, and how rationalisation should be initiated is problematic. Essentially a market-based approach through privatisation or a government-directed approach are the only feasible alternatives.

Local Government New Zealand keeps telling the business sector that councils are addressing the problems and understand the need for change. It maintains that councils should be allowed to make decisions at their own time and speed. This case is wearing thin. I remain highly sceptical that most councils will implement any significant change unless they are firmly directed by central government. The prospective roading reforms would never have happened if they had been left to local government. It is perfectly appropriate for central government, which has the responsibility for determining the framework in which local government operates, to require similar changes to the water industry.

Too much is at stake. The New Zealand economy is seriously under-performing relative to its potential, and the gap between average incomes here and in more successful countries is wide. Inefficiencies in the water industry are holding the whole economy back. Those who profess to be concerned about problems of low incomes and unemployment should be calling the loudest for reforms. Unless central government insists on changes, my fear is that in another four years we will still be discussing the same problems and issues, and that the industry's performance will be lagging even further behind international best practice.

# EDUCATION AND THE LABOUR MARKET

PORT NICHOLSON ROTARY CLUB

# SCIENCE AND THE KNOWLEDGE ECONOMY

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EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

WELLINGTON
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# SCIENCE AND THE KNOWLEDGE ECONOMY

Much has been made lately of the 'knowledge economy' and its importance to our future. Concern has been expressed about the allegedly low number of science and technology graduates emerging from tertiary education and about New Zealand's low level of investment in research and development (R & D) relative to other advanced countries. Both major political parties have developed elaborate plans to invest in our future by fostering research, technology and innovation in New Zealand, in partnership with the private sector.

Today (18 August 1999) the government is announcing its 'Five Steps Ahead' programme, which has been heralded as including elements such as:

- better focusing the direction of the government's effort in research and development;
- developing closer linkages between enterprise, research and tertiary education;
- improving access to risk and investment capital; and
- ensuring regulations and laws support, rather than frustrate, innovation.

Some of this programme, as foreshadowed, makes good sense. Entrepreneurship and innovation are vital to growth. In general the programme does not look like a lurch towards active government direction of industry. The practical effect of much government intervention is to stifle, not encourage, entrepreneurship. Max Bradford, minister for tertiary education, has said that "the government does not believe politicians or bureaucrats are the right people to judge what is, or isn't, a good idea". Instead he has told business that the focus is on:

> ... getting government out of your way ... as little regulation as possible, a simple tax regime, flexible laws such as employment and accident legislation ... .

As a statement of intent, this is hard to fault. The trouble is that it is also hard to square with what the government has actually been doing in recent years. There has been an avalanche of new laws and regulations – some 5,200 at last count – over the past decade, which have added enormously to the costs of doing business in this country. What is more, the flow has not stopped – the government has been busy this year promoting things like price controls for electricity, new restrictions under the Commerce Act 1986, additional disclosure obligations in telecommunications and environmental regulations in areas ranging from energy efficiency to biodiversity. At the same time it has been making the tax system more complex rather than simpler, and it has failed to deal with obstacles to employment such as the Employment Court and the Holidays Act 1981.

All of these things suppress entrepreneurship and help explain why the business sector and the economy are struggling. If the government is serious about promoting economic growth, today's package should be grappling with the basic problems of high tax and regulatory burdens that are holding business back. It does not look as though it is addressing the most fundamental issues.

We should also be wary of some of the hype associated with discussions about technology and the knowledge economy. You may remember British prime minister Harold Wilson's talk about "the white heat of the technological revolution" at a time when growing state interventions were strangling the British economy to the point that it ended up in the hands of the International Monetary Fund in the 1970s. Many myths and misdiagnoses of problems arise in discussing science and technology and they need to be unravelled.

Take, for instance, the proposition that New Zealand is producing too many lawyers and not enough scientists. In a recent paper Warwick Bishop of the Institution of Professional Engineers New Zealand looked at the figures and found that the overall number of science graduates produced each year by New Zealand universities compares well with our Organisation for Economic Cooperation and Development (OECD) partners. Moreover, although many science graduates go overseas after leaving university, the pattern has been for a high proportion of them to return. Warwick Bishop's conclusion was that what we were lacking was not scientists but wealth creators.

If anyone thinks we have too many lawyers in this country, the obvious question to ask is whether we have too much law and too many bad policies. Businesses have to hire lawyers or legal advisers to deal with the mass of law that politicians and courts have been generating. Dismissals now raise the possibility of grievance cases almost as a matter of course. The grey areas in competition law and the government's endless proposals to regulate network industries must be generating an enormous amount of work for lawyers. The Resource Management Act 1991 has created a legal industry of its own. Then there is legal aid – now a $100 million annual subsidy – and the totally open-ended and taxpayer-supported litigation over Treaty of Waitangi claims.

We should not operate on the assumption that businesses, tertiary institutions and students are irrational. Businesses will hire people whose skills are most essential to their operations – if lawyers are more important than scientists to their survival, they will hire lawyers. For their part, students will go to where the rewards – financial and otherwise – are greatest. And tertiary institutions will heed student and employer demand. If we do not like the outcomes of these rational decisions we should be asking questions about the government's influence on the environment in which they are made.

We should also be looking at our performance in maths and science at the school level. International surveys have been pointing to low levels of achievement in this area. We appear to have significant shortages of good maths and science teachers, and this will remain the case so long as a rigid national award system does not allow for proper pay differentials. The new maths and science curricula have been criticised as lacking solid content by international experts, and the proposed new schools qualifications look like a weak, politically driven compromise between examinations and unit standards. The virtual state monopoly of education suppresses innovation in the sector. Despite all the talk about a knowledge economy, it is knowledge and innovation that have been the persistent casualties in the education system.

There has also been a lot of loose talk about the reliance of the country on primary industries and the need to move into 'added value' and 'high technology' industries. Several points need to be made here.

First, it is nonsense to confuse price with income. The price of a silicon chip has collapsed compared with the price of a rack of lamb or a tray of kiwifruit. So has the price of Microsoft's software, adjusted for quality. Yet the founders of Intel and Microsoft have earned fabulous incomes. Ray Kroc made great wealth producing a basic commodity – the Big Mac. Starbucks has prospered on a basic commodity – coffee.

Secondly, a fall in prices associated with increasing output points to superior productivity. New Zealand farmers keep producing more output with fewer labour and capital inputs, despite being handicapped by inefficient producer boards. The key to success in any business is continuing productivity improvements.

Thirdly, income depends on performance, not technology. Sports stars Michael Jordan and Jonah Lomu do not get their income from high-tech activities. High-tech films can flop.

Most importantly, however, we should look at what drives the structure of production in our economy. We have what we have because of the constraints our businesses and entrepreneurs face. If primary production is dominated by outdated producer board structures, why would we expect innovation in sophisticated and branded consumer products to flourish? If businesses are constrained by the outputs of a mediocre government-dominated education system, a history-driven pattern of scientific research and a tax system that pushes companies and entrepreneurs offshore, how much entrepreneurship can we expect?

The bottom line here is that New Zealand businesses can be relied on to work out for themselves how to do best in the environment that confronts them, and the economy is wide open to entry by any business from overseas that thinks it can do better. Any politician who thinks businesses are getting it wrong should put their own money on the line if they are so sure that opportunities are going begging.

We are also told that New Zealand invests too little in research and development compared with other countries. But this argument also suffers from problems. R & D is an investment like any other, and what matters is the rate of return on any investment. More is not better if the returns do not justify the costs. Countries will have a comparative advantage in particular lines of R & D. New Zealand businesses can conduct R & D in New Zealand where it is profitable to do so or buy it from overseas in a myriad of ways. We benefit from Microsoft's R & D regardless of where Bill Gates sites his business or develops his software. It has become fashionable to point to Ireland as a success story in some high-tech industries. However, relative to gross domestic product (GDP), Ireland spent relatively little more on R & D than New Zealand in the first half of this decade – some 0.98 percent of GDP on average compared with our 0.88 percent.

Moreover, such comparative statistics are often misleading as they are distorted by factors such as defence expenditures and government incentives provided to R & D. I have no doubt that if we started subsidising private sector R & D activities, a great many more would suddenly materialise, just like the miraculous increase in the number of sheep when Supplementary Minimum Payments were introduced. There is a large arbitrary element in deciding whether or not some business expenses should be classified as R & D. Important product and process innovations may occur as part of the normal operations of an innovative firm – as a result of management decisions to try something different – rather than as a result of work undertaken in a laboratory. There is no particular reason why R & D undertaken by people wearing white coats should necessarily yield a higher return to the nation than, for example, the analysis of sales figures for a firm's markets to get a better understanding of consumer demand. From a public policy perspective, the important issue is whether or not the regulatory environment in New Zealand impedes the search for better processes and better ways to meet consumer requirements. The extent to which that search should be undertaken through activities that may be classified formally as R & D is a matter that individual firms are much better placed to decide than governments.

Some argue that the government can help businesses by selective grants and tax breaks. But what this argument overlooks is that a subsidy to one industry is inevitably a tax on some other industries. For every winner a government picks, it creates a loser somewhere also. Firms that only become more profitable because of the government grant expand while others that could otherwise stand on their own feet are forced to contract because of the tax. In the process resources are misallocated into less socially productive activities and overall tax rates are pushed up to pay for the subsidies. Such industry policies also breed a culture of rent-seeking and cronyism which was all too familiar in New Zealand in the Muldoon era and in some Asian countries in more recent times.

Research and development is often presented as a field that needs special support from government. Some of the arguments for a government role in this area are weak. For example, it is sometimes suggested that the government has some unique strategic advantages and needs to act as a national champion in the face of global competition. Professor Howard Frederick of the New Zealand Internet Society, in a study funded by the Ministry of Research, Science and Technology (MoRST), warns that unless a champion is found, New Zealand will be left behind in electronic commerce. Yet, according to Ernst & Young's study of e-commerce, New Zealand is perhaps the most networked country in the world. We have exceptionally high growth rates in business-to-business e-commerce. For Professor Frederick this is all at risk without a national champion and other government interventions to deal with what he calls the "bewildering" number of choices. This view may be contrasted with that of Paul Rudolph, president of EDS, who recently stated that:

> New Zealand is an incredible country for e-commerce establishment. It is ready. It has the infrastructure. It has a population of a demographic characteristic that embraces technology. It has a strong business culture. It's a free market society. It's perfect – this could be a model.

One might add: a model only for as long as the government can restrain itself from intervening, appointing national champions and the like.

A stronger argument for government involvement in R & D is that, especially with basic research, the returns are too diffuse for private companies to undertake such investment. This 'market failure' argument is the basis for public funding of so-called public good research. However, this is a difficult area for government intervention and the case for it should not be overstated. Large US companies engage extensively in basic research and some of the highest performers are the highest investors. Much new technology derives from existing technology, and indeed applied technology often precedes any deep understanding of the underlying theory. Nor does state investment in R & D necessarily translate into an increase in overall R & D spending – studies suggest that governments which provide major funding displace private sector activity. The ratio of government spending on R & D in New Zealand to spending by industry is the sixth highest in the OECD. Moreover, the deadweight costs of the higher taxes needed to finance public science must be balanced against the value of whatever knowledge is gained.

Also, before we accept the 'market failure' rationale for taxpayer-funded R & D, we should review the risks of government failure. Political or bureaucratic influence, not some 'objective' evaluation of national benefit, can too easily determine who and what will be funded. Public good science funding can ossify into support for the status quo in research allocations or mutate into a variant form of pork-barrel spending based on the latest fad.

There may well be a risk of such politicised developments with the MoRST Foresight project. The Foresight papers contain much material about vision, and something called a "strategic, far-sighted and pro-active strategy". We are told that a "vibrant and thriving knowledge-based society" will be "underpinned" by activities fostered through Foresight. MoRST's document *Blueprint for Change* talks about Foresight "constructing a vision of a desirable future, and then identifying strategies to take you there". The very title *Blueprint for Change* implies that somebody has the knowledge and capability to plan a path for change, in this case national economic change. Professor Leon Phillips of the University of Canterbury has likened the approach to Soviet-style central planning of science.

The document is full of pretentious language. Four "science envelope goals" are set out:

- an innovation envelope goal (which links back to the national innovation system);
- an economic envelope goal (which is where enterprise and competitiveness get a mention);
- an environmental envelope goal; and
- a social envelope goal.

From these "envelope goals" 14 target outcomes are developed, including "future focused global intelligence", "strong families and communities", "Maori development", "vibrant culture and identity", "resilient ecosystems", "the global biophysical environment" and so on. Such outcomes may well be desirable but the extent to which the government's research activity can reasonably be expected to contribute to them is very doubtful. The Alliance Party's election manifesto will probably be less ambitious.

Presumably, any particular research proposal will not have to hit all 14 target outcomes. However, an astute applicant may well slip a few remarks about resilient ecosystems, vibrant culture and Maori development into even the most mundane or abstract research proposal. Indeed, purchase agents – referred to as "stewards" by MoRST – are told they must meet wide-ranging expectations including:

- "using strategic analysis as the basis for Government's investment";
- "responsiveness to Maori"; and
- "optimising global connectedness".

This is heavy freight for research proposals – whether commercial or academic – to carry. Much of it is entirely irrelevant to most research programmes. Critically, there can be no effective accountability for the wise use of taxpayers' money under this framework. Any allocation decision is as good as any other when objectives conflict and there are no objective criteria for resolving conflicts. This is a sure recipe for capture by interest groups and providers. In consequence, Foresight is likely to give birth to a whole industry of flimflam and rent-seeking, in good part at taxpayers' expense.

MoRST's proposals would no doubt increase its own status but it is not necessarily serving New Zealand science well to bring our researchers into a politically correct twenty-first century. In talking of the "strategic, far-sighted and pro-active strategy for focusing on the achievement of outcomes", MoRST states: "This ethos will also need to be imbued in all of the scientists and technologists that are funded by the Government". So much for science as a discipline devoted to building objective knowledge, knowing not where it will lead. Foresight is a good illustration of how ill-equipped, indeed dangerous, bureaucrats can become when they try to steer research, science and technology. Will good serious scientists be lost to New Zealand because of such claptrap?

The focus of government involvement in R & D should be on public good research. Investments should be tested on three criteria, non-appropriability, national benefit and likelihood of success. This focus was clearly established in the science policy reforms of the 1980s but appears to be in danger of being diluted. We risk a renewal of rent-seeking by private sector interests looking to access funding for projects that do not meet strict public good criteria.

If the government is really serious about creating a better climate for entrepreneurship and innovation in this country it must focus its efforts on reducing the barriers that entrepreneurs face. The priority task should be to stick to Max Bradford's stated but unfulfilled aim of "getting government out of your way". The government's direct role in undertaking public good science is a more modest one, but there is certainly work to be done to reduce the extent of state ownership and control of our universities and Crown Research Institutes and to improve their linkages with the private sector.

Our flagging reform process is deterring mobile capital and labour and dragging down the rate of economic growth. The prime minister's wish to "foster a passion for enterprise, hard work, skill and creativity" is to be applauded. But if we are to promote these attributes in the private sector, the government must move to curb the restrictions it imposes on the business sector and significantly reduce the massive 41.5 percent of GDP that is absorbed by central and local governments. Such action would do far more than the Foresight saga to provide the platform for science and technology to flourish.

**COURSE ON CONTEMPORARY EDUCATION POLICY IN NEW ZEALAND**

**MASTER OF EDUCATION PROGRAMME**
**VICTORIA UNIVERSITY OF WELLINGTON**

# THE CURRICULAR REFORMS – ARE THEY TAKING US FORWARDS OR BACKWARDS?

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**WELLINGTON**
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# THE CURRICULAR REFORMS
# – ARE THEY TAKING US FORWARDS OR BACKWARDS?[1]

My task today is to discuss the policy process used in the development of the new school curricula and to tease out some of the results of what I see as the serious deficiencies in that process. I will touch on some of the structural and philosophical assumptions underlying the new curricular documents and the purposes of schooling that seem to be driving them.

**Consultation on the curricular documents**

I need to spend some time on various aspects of the consultation process used in the development of curricula because I think it has led to some of the problems in the curricular documents to which I will refer later. I should emphasise that I am talking about documents that are, or have become, public. Parts of the process, for example discussions between the writers and their reference groups and between the ministry of education (the ministry) and the writers, are not accessible to outsiders.

*The submission process*

My basic problem with the current submission process is that the ministry asks for submissions on the first draft of the final document and does not tell us of the various ways in which a curriculum might be constructed, the alternative assumptions on which it might be based, and the reasons for choosing certain options and not others. Contentious statements are made or implied, but it is far from clear that the nature and implications of what is said have been understood and alternatives explored.

As regards the curriculum framework, there were many fundamental decisions to be made. In a speech to an Auckland University audience I listed several major ones, such as:[2]

- How many years of schooling should the framework cover?
- Should there be one or more curricular pathways?
- Should the framework be structured in terms of ages, stages or levels, and how many should there be?

All we were given in the draft and final framework documents were the proposed and final answers to such fundamental questions, but we do not know how the ministry came to the answers they did. Indeed it often seems that there are lots of answers floating around unattached to specific questions.

I have urged the ministry to issue discussion papers with the draft curriculum statements. At the end of an exchange of letters, I wrote to the senior manager in the ministry concerned with curricular policy summarising what I saw as unsatisfactory in the process:[3]

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1 This speech is based on an address given to a conference organised by the School of Education, the University of Waikato, and held in Hamilton on 10 and 11 June, 1999. It was reported in the *New Zealand Education Review* of 18 June, 1999. An article on the same subject under the heading of 'A Decade of Curricular Reform' is to appear in a forthcoming special edition of the *New Zealand Journal of Educational Studies* to be entitled 'A Decade of Reform in New Zealand Education: Where to Now?'.

2 Irwin, MDR (1996), 'Curricular Confusion. The Case for Revisiting the New Zealand Curriculum Framework'. Paper presented to the seminar on implementing the curriculum, Principals' Centre, University of Auckland, 18 October.

3 Irwin's letter to Ministry of Education of 24 September, 1994.

> Surely it is simply not satisfactory from the perspective of usual professional standards to assert that work has been undertaken with reference to research without being able to document the research and its relevance to the issue under investigation. Or to refer to a literature search without being able to indicate what literature was in fact consulted and what conclusions were drawn from it. Or to state that all submissions on the ... draft curriculum were carefully considered and key points taken into account when there was no written identification of what the key points actually were. Or to advise that there was lots of thoughtful analysis [of certain curriculum developments] by highly competent people over a long time when there appears to be no significant written evidence of this whatsoever. And so on.

Well, that exchange was over four years, and several curricula, ago, and little has changed. Certainly increasing amounts of material are becoming available about individual curricula including literature reviews and other background papers prepared for the ministry. But we still do not know how and why the ministry came to the decisions embodied in the drafts. Moreover, the drafts are presented as if they represent the only proper way to consider the curriculum in question and only marginal issues are open for consideration.

And as with other processes, the value of what you get out depends very much on the quality of what you put into it. Of course there should be wide consultation, but it should be based on well-prepared discussion documents. A national curriculum should be developed in an open, transparent and contestable way, and I do not think this is happening.

***The analysis of submissions***

There are also problems with the way in which the submissions are treated.

I recently pointed out to the ministry that the analysis of submissions on the draft Health and Physical Education (HPE) curriculum was entirely quantitative, that is it counted the numbers of submissions for and against various aspects of the draft. I asked for any ministry papers discussing the quality of the submissions and the reply was that there was none but that "each of the major submissions was fully discussed during the rewrite process".[4] Again, we only have the ministry's assurance that somehow, somewhere, some people fully discussed the submissions, assessed their quality and decided what, if any, changes should be made as a consequence.

What happens to submissions is that they are put into the educational equivalent of the shredding machine that operates at the landfill I go to sometimes just north of Wellington. There householders and the parks and reserves people bring their waste vegetation – everything from hedge clippings to whole trees – roots, trunks, branches, twigs and all. Everything is fed into this enormous shredder which chops it all up and out of which everything emerges at the other end as fine composting material of roughly equal size and form – whether it started as a leaf, a twig, a branch or a whole tree.

4 Ministry of Education's letter to Irwin of 24 February, 1999.

So it is with submissions on draft curricula.[5] Submissions of all shapes and sizes, from a one-sentence comment on one aspect to a comprehensive 100-page report are all fed into the ministry shredder which reduces all of them into ticks and crosses, that is into decisions for or against a particular proposal within, or an aspect of, the draft document in question. The resulting analyses are entirely quantitative. Qualitative aspects of submissions are lost in the process.

To revert to my composting illustration, whole trees are treated as if they are no more than a mass of chips and everything that held them together – roots, trunk, and branches – are dismembered, and in the process they lose whatever integrity they have as parts of a whole. The rigour of analysis, the command of the relevant literature, the clarity with which problems are identified, distinctions made between symptoms and causes, the linkages made between the analysis, conclusions and recommendations are not reported on as if of no consequence to ministry officials. Lest I be misunderstood, I am *not* saying that all lengthy submissions are well constructed and rigorous or that all short ones are devoid of pertinent and useful comment – that would, of course, be nonsense.

The analyses of submissions usually allocate comments according to the structure of the draft document on which the submissions are made. This immediately puts at a disadvantage any submission which urges an entirely different approach. Such alternative approaches tend to be dismissed. For example, the report on the written responses to the draft Health and Physical Education statement notes that:[6]

> Disapproval of the [draft curriculum's] overall content and direction came from a small group of organisations and from one school.

There is no examination of the quality of these submissions – no suggestion that the objections raised should be examined carefully and might have some validity, and that changes in the overall direction were up for reconsideration. Indeed the clear implication is that because such strong objections are confined to a very few organisations they can be dismissed. Consider, for example, the following statement in the executive summary:

> Given the large measure of clearly expressed support, the Ministry would be well advised to retain the main thrust and direction of the draft [curriculum]. Any major shift in overall philosophy and content would be difficult to justify.

It could hardly be clearer that the quantum of support is the only thing that counts in submissions – not the quality of their arguments.

***Reporting to ministers on the submissions***

It would at least be a relief to find out that the ministry in its reporting to its ministers filled the qualitative gap left by the analyses of submissions. I have not seen all the relevant ministry reports, but certainly the ministry's two reports on the Health and Physical Education curriculum did not make up for the inadequacies of the analysis of the submissions. Neither report has any conceptual analysis of the issues and they concentrate on reassuring statements about the extent of support for ministry proposals and that, for

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5 This quantitative approach to submission analysis is not confined to submissions on draft curricula – see, for example, the analysis of submissions on the assessment Green Paper (Gilmore, AM (1998), *Assessment for Success in Primary Schools – Report on the Submissions to the Green Paper*, University of Canterbury, November) which weighted submissions from groups of individuals to reflect the number contributing to them. However, organisational submissions were weighted one, since "it was impossible to determine the number of individuals represented in the submission". The quantitative approach to setting policy targets can be seen in Smith, L (1994), *Education for the 21st Century*, Learning Media, Wellington.

6 Duthie, B and van Aalst, I (1998), *Written Responses – Draft National Health and Physical Education Curriculum Statement*, Report prepared for the Ministry of Education, September.

example, rewriting was informed by the results of various processes and that many suggestions had been taken up. Both note that a tiny minority of submitters were strongly opposed but no reasons were given for dismissing their arguments. Here again the implication is that such a small minority can be discounted – that it is the quantity of support that matters, not the quality of the argument.

The only reference to philosophical underpinnings is in the first of the two ministry reports which says that the issues raised by the Education Forum, with which I am closely associated, had been considered by the Policy Advisory Group (PAG) which reaffirmed the policy specifications which had informed the development of the curriculum statement.[7] It does not say what these issues are. The four-page PAG report contains several reassuring statements to the effect that all issues had been "debated", "considered" and such like.[8] The few substantive statements that are made (for example that "knowledge is a social construction") jump out at you without warning or explanation, and I am left wondering whether the authors had fully considered the implications of what they were saying.

The second ministerial report on the HPE curriculum makes the following reassuring statement:[9]

> In Health we have moved from a hygiene or sanitation model at the turn of the century, to a lifestyle, behavioural or medical model in the 1970s and to a holistic, social-ecological model of health in the 1990s. The new curriculum is based on a holistic view of health which encompasses physical, mental and emotional, social and spiritual well-being and acknowledges the impact of social and environmental factors on health and well-being.

Fine sounding stuff with lots of 'feel-good' words – but also very question-begging! Again there is no discussion whatsoever – just assertion – as if the issues were entirely non-problematic.

Well, so much for the public consultation processes except to say that it is not surprising that a whole lot of assumptions get buried and are not identified and debated – at least not in the public arena. It is not just a terrible way to conduct a public debate about a national curriculum. It also means that an enormous burden of change has been imposed on all teachers, trustees, parents and children on the basis of a very poor quality policy development process.

I now want to turn to the actual assumptions that were largely buried in the curriculum development process.

**Structural assumptions**

There are all sorts of assumptions in the curricular documents about the way in which curricular material should be structured. Some of the main ones include:

- that the national curriculum should cover all ages and stages of school education;

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7 Ministry of Education (1998), Report to Minister of Education entitled 'Publication of the National Curriculum Statement Health and Physical Education in the New Zealand Curriculum and revoking the Health, Physical Education and Home Economics Syllabuses', 26 November.

8 Twigden, D (1998), Report to the Secretary of Education by the Policy Advisory Group on Health and Physical Education, 24 November.

9 Ministry of Education (1999), Report to Minister of Education entitled 'Publication of the National Curriculum Statement Health and Physical Education in the New Zealand Curriculum', 2 February.

- that the curriculum should make explicit the expected effects of education on the inner life of children under concepts such as "well-being", "personal identity" and "self-worth", and seek to inculcate specific attitudes about the way society should be ordered, for example on the Treaty of Waitangi, partnership and biculturalism;

- that essential learning areas are a better way of assembling curricular material than the traditional subject or disciplinary approach;

- that some subjects can be integrated without distortion, for example history, geography and economics within social studies;

- that all material can be ordered within the same structure of strands, levels and outcomes and that the structure can be determined independently of curricular content;

- that differences between kinds of skills, between subjects, and between subjects and other kinds of learning are irrelevant to the way in which a curriculum framework can be constructed;[10] and

- curricular material should be specified in terms of outcomes and not content.

All these assumptions are, at the very least, questionable and will in time be increasingly questioned.

I have little doubt that eventually our extraordinary wholesale leap into an outcomes-based method of curriculum specification will be seen as most unfortunate. The idea is superficially attractive: in the interests of accountability we should surely concern ourselves with children's actual achievements. How children should attain the desired outcomes can safely be left to the professionalism of teachers. On the face of it, this sounds very sensible. But what we find, as we browse through most of these new curricula, is extraordinary vacuity. There is very little recognisable content. For example, here are some objectives from the new English curriculum in the strand for "expressive writing":

Level 1: write spontaneously to record personal experiences

Level 3: write regularly and with ease to express personal responses to different experiences and to record observations and ideas

Level 5: write regularly and confidently to respond to a range of experiences, ideas, observations, and texts, developing a personal voice

Level 8: use expressive writing regularly, fluently, and by choice, to reflect on, interpret, and explore a wide range of experiences, ideas, feelings, and texts, expressing complex thoughts in a personal voice.

In addition to their lack of content, what is striking about these objectives is the number of adverbs like "regularly", "confidently", "fluently" and so on which are capable of a wide range of interpretation. For example, how often does a child have to write in order to reach the "write regularly" requirement? How fluent is 'fluent'? Yet we are also told that learning outcomes are to be so 'clear' that students' achievement can be assessed against them. And are we not in danger of dividing up material into such small bits that we lose

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10 Subjects can be understood as ways of establishing different kinds of truth about the world; applied education consists of practical applications of knowledge (eg engineering and medicine); and occupational training is defined by specific tasks. In its concern to deny the so-called 'academic/vocational divide', the New Zealand Qualifications Authority (NZQA) has tended to play down these differences. See Smithers, A (1997), *The New Zealand Qualifications Framework*, Auckland: Education Forum, pp 40–41.

the sense of the whole and the relationships of the various parts? Cardinal Newman stressed the importance of intellectual coherence:

> How many writers are there ... who, breaking up their subjects into details, destroy its life, and defraud us of the whole in their anxiety about the parts.[11]

We have very much the same problems with unit standards, but we do not seem to have learnt much from our experience with the National Qualifications Framework (NQF).[12]

With the outcome-based curricula we have yet again the problem of a superficially attractive notion being pushed far beyond its proper limits. A structure for curricular material has been determined without regard to differences in the material to be placed within it – everything has to be forced into the same procrustean bed and it is too bad if some things have to be distorted in the process. Outcome specification may be useful where outcomes can be readily defined, but in other cases, for example higher order critical skills, this is not so.

**The philosophical assumptions**

The more obviously 'philosophical' assumptions include postmodernism, constructivism, the needs-based and student-centred approach to education and relativism. It is difficult to discuss these with assurance because of the lack of explicit ministry discussion on them. Another difficulty is the complexity of the issues including the fact that one is talking about locations on a range of possible positions, and often one has to consider several dimensions not simply one linear range.

But the lack of any acknowledgment of these influences has led to some obvious tensions and contradictions. For example:

- How is the confident rationalism of modernity, evident in the conviction that all education can be reduced to clear outcomes against which pupils can be assessed, to be equated with the doubts of postmodernism and constructivism, evident elsewhere, about the possibility of objective knowledge?
- How can the "socio-ecological perspective" and the concept of "well-being" be advanced in the face of postmodernism's rejection of such meta-narratives?
- How can child-centredness be combined with an undifferentiated curriculum?
- How is the promotion of critical skills to be equated with the promotion of particular views about society which are to be accepted without question?
- How is the scepticism about objective moral judgment to be combined with the promotion of particular value judgments?
- If there is no moral reality beyond individual values how can any objective value be attached to the individual child?
- Should spirituality be promoted in the absence of the theological understandings important to many parents and children, and in what does it consist?

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11 Newman, JH (1891), *The Idea of a University – Defined and Illustrated*, London: Longman, Green, and Co.

12 A very early critique is 'Designing the Framework – A Position Paper on Problems and Issues in the Restructuring of National Qualifications' by Codd, J McAlpine, D and Poskitt, J, Education Department, Massey University, 1991. This identified many of the problems which arose later as the NQF was developed and implemented. There are numerous subsequent critiques.

- How can the problem of self-harm among young people be addressed in the context of values relativism, which undermines standards of right and wrong, and in the absence of theological awareness which for many provides a basis for meaning in life?

***Rigorous eclecticism*[13]**

I should note a very recent contribution by the ministry on the question of its philosophical assumptions. This is a four-page memorandum[14] distributed with background material on the draft Arts curriculum statement.

The basic position advanced in the memorandum is that "New Zealand seeks to adopt an approach of *rigorous eclecticism* with respect to the underpinning philosophies of its curriculum documents" (emphasis added). No single philosophy is be adopted or dismissed without serious consideration. The key criterion for adoption is the potential for contribution to the overall quality of the work being undertaken. The memorandum analyses the principles of the framework and demonstrates the influence of varying philosophies on them and this is seen as evidence of rigorous eclecticism. The draft Arts curriculum is viewed as displaying the same eclecticism.

But it seems to me that there are still questions to be answered. Again we are left with assertion and not analysis – descriptions of choices but not reasons for them. In the first place it is not clear what "rigorous eclecticism" actually means. Does the qualifier, "rigorous", refer to the deliberate avoidance of reliance on any one philosophy or does it mean that the criteria for selection from various philosophies are rigorous? If the former, it is still unclear why reliance on one philosophy should be dismissed out of hand as a matter of principle. If the latter, then one would want much more specific criteria than simply the unelaborated reference to quality including criteria for resolving conflicts between philosophical positions and between philosophical preferences and socio-political objectives such as those mentioned in the memo including perceived Treaty of Waitangi and equity objectives. In short, do we find in the curricula documents a careful *selection* or an untidy, haphazard *accumulation* of ideas. The memo uses the word "amalgam" which would seem to suggest the former, but the basis on which the ministry's philosophies are thought to combine is not provided.

Even if there has been deliberate, careful selection, why should we accept the ministry's particular choice? Is its brand of eclecticism any better than yours or mine? If the ministry's philosophical choice is optimal then we need to know why it is considered to be so and to what other alternative selections it was preferred. In the absence of such information, there are no grounds for believing that its eclecticism is any better than anybody else's.

The cynic in me suggests that "rigorous eclecticism" is a convenient *ex post* rationalisation for the "amalgam" of the sometimes conflicting influences that are to be found in the curricular documents and is advanced as a defence against the charge of inconsistency. You will have noted that it is *New Zealand* that seeks to adopt "rigorous eclecticism", not just the ministry. I never knew this until two months ago, and I wonder how widely and for how long this was known even within the ministry.

Moreover, the basic argument has a circular flavour: the framework principles reflect various philosophies and hence demonstrate eclecticism; our philosophic approach is eclectic therefore you must expect to find various influences and, perhaps, some

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13 I am indebted to Glennys Allen for comments on an earlier draft of this section.

14 Memo dated 12 May, 1999 entitled "Policy Framework for *Arts in the New Zealand Curriculum: Draft Statement*" from the Learning and Evaluation Policy unit, Ministry of Education, to the Secretary for Education.

inconsistency in the curricular statements. Superficially this is all very convenient, but where does it take us? Not very far I suggest. There is still a lot of work to be done.

**The purpose of schooling**

At the heart of much of the debate about the curriculum is the clash of views about the purpose of education. Three emphases struck me as I went through the documents: the economic emphasis with a focus on turning out young people with particular vocational skills and aptitudes; the emphasis on schooling to turn out critical theorists who can reconstruct society; and the emphasis on the inner life of children through concern for their well-being, personal identity, self-worth and such like.

I have reservations about all these emphases. I am concerned that matters which were previously contingent on education – vocational preparation and the development of skills and character – have now become of its essence. The deliberate attempt to inculcate certain views about the way society should be ordered – as opposed to inculcating personal values such as honesty and self-discipline essential to educational endeavour and much else in life – can be dangerous.

What is lost in the current reforms is the sense that education has intrinsic value – that it has something to do with living a worthwhile life and becoming human through engagement with a moral and intellectual inheritance of great worth. The point about education is that it is, or should be, open-ended.[15] How children will respond cannot be predicted. We would like to think it will make them cultivated, but that can take many forms. As soon as we try to predetermine the results, which the outcomes approach seems to encourage, we have abandoned education for indoctrination.

It is worth reflecting how utilitarian the official view of the purpose of education has become by rereading some of the works of those who thought deeply about education only a generation ago. M Oakeshott, writing in 1972, said that his greatest fear was the socialisation of education by which he meant the systematic apprenticeship to domestic, industrial and commercial life. For him education has no such extrinsic purposes; it is the disinterested study of the best that has been thought and said – not the pursuit of goals external to itself such as we find in many of New Zealand's new curricular documents. Indeed, he saw socialisation (as he defined it) as "the most momentous occurrence of this century, the greatest of the adversities to have overtaken our culture, the beginning of the dark age devoted to barbaric affluence".[16]

RS Peters, writing at the same time as Oakeshott, said that education involved getting children, who start off as "barbarians outside the gates", inside the "citadel of civilisation so that they will love and understand what they see when they get there".[17] He emphasised that the "activities and modes of thought and conduct which define a civilised form of life are difficult to master" and involve not happiness but "an uphill task in which there are no short cuts". The contrast between these views of just a generation ago and that which comes through in the curricular documents is stark indeed. From the older perspective, the citadel of education as now defined by officialdom has already been invaded and the barbarians are in charge.

I do not, however, want it thought that I think that schooling has no vocational purpose. I have argued elsewhere that more account should be taken of children's varying abilities,

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15 Minogue, K (1996), 'European Identity', paper given to the Schools Curriculum and Assessment Authority conference on Curriculum, Culture and Society, London, February.

16 Oakeshott, M (1972), 'Education: The Engagement and its Frustration', in RF Dearden, PH Hirst and RS Peters, *Education and the Development of Reason*, London: Routledge and Kegan Paul.

17 Peters, RS (1972), 'Education as Initiation', in RD Archambault (ed), *Philosophical Analysis and Education*, London: Routledge and Kegan Paul.

interests and aspirations, particularly in the middle and senior secondary curricula. But the curriculum must also provide training in morality, and provide opportunity to engage with the riches of our cultural inheritance.

One of the underlying problems is, I think, the confusion, to which I have already referred, between what I see as the essence of education and its contingent benefits. Undoubtedly education has benefits for the vocational sphere as for many other areas of life. But education becomes corrupted when those contingent benefits become of the essence and drive our school curricula. I see the same tendency at the university level. The territorial ambitions of some of our universities into vocational areas will, I suggest, have at least two unfortunate consequences. First, it will make it increasingly difficult for them to reject applications from those who are unsuited to traditional university level work – to the pursuit of knowledge for its own sake. Secondly, universities will become increasingly beholden to employers. Of course, universities have always had a vocational side – initially the training for the church and government administration and then for the so-called learned professions. But this vocational side was seen as contingent on, and subordinate to, the essence of their existence. Now, I fear, what was contingent is increasingly seen as the essence.

**Some conclusions**

Current reforms have been presented as inevitable progress, for example as part of a necessary substantial overhaul of the Thomas reforms of the 1940s. I noted earlier how the Health and Physical Education changes were presented to the minister. The structure of outcomes is seen as indubitably superior to that of content.

The extraordinary ambition of the reforms – the extent of their coverage, the explicit concern for the inner life of the child, and the massive structural changes – has brought, I suggest, its own problems. The more the curricula attempt the more they are likely to become bogged down in the sorts of contradictions to which I referred earlier and which will confuse teachers and ultimately bring the curricula into disrepute. I do not think, by the way, that consistency is everything – there are too many tensions and trade-offs in real life. But it *is* very important to be clear about, and to be able to defend, our choices.

An appeal to rigorous eclecticism does not help very much. If a national curriculum is to command widespread and enduring respect, it cannot ignore such questions. So the first conclusion I draw is that the more you attempt the more important it is to be rigorous in identifying problems and evaluating possible solutions. Unfortunately uncritical adoption of internationally modish ideas has often substituted for serious analysis.[18] The quantity of inadequately informed support rather than quality of analysis has driven the curriculum development process.

My second conclusion is that the more you try to include in a national curriculum the more you are going to get off-side with people. So rigorous consistency is not the complete answer. There is no way that everybody in a pluralist society is going to agree on the purposes of education and the means to achieve them. We all come with our own baggage and, in an open society, that is how it should be and always will be. I am conscious that my own views may well be wrong – at the very least in some circumstances and for some children. But so may yours and, more particularly, so may the ministry's.

One of the obvious features of schooling is the high level of individuation. Every child, parent and teacher is different. Yet we have a highly centralised government education

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18 Irwin, MDR (1997), 'Follies and Fashions in New Zealand Education', paper presented at the Waikato Forum on Education, University of Waikato, 7 August; and (1998) 'The Education Debate in the 1990s: An Intellectual Adventure or Unexamined Orthodoxies', paper presented to the course on 'Learners Learning and Teaching in Context', Wellington College of Education, 8 April.

system which, in spite of much talk about the importance of the individual child and multiculturalism, seeks to treat them all in much the same way within a largely undifferentiated curriculum. We do not expect central direction for mass-produced consumer goods like motor cars because we know it does not work, yet we think it will somehow work in schooling. So the answer in my view is to reduce greatly the educational portfolio of the government, including its curricular functions.[19]

In a report I wrote five years ago on the qualifications, curriculum and assessment reforms,[20] I came to the conclusion that the national curriculum should be restricted to the essential content of core subjects which would reduce from, say, two-thirds of each subject in the primary years to, say, half in the junior secondary years with the remainder to be decided by each school. Statements would describe in simple clear language the essential knowledge, understandings and skills that should be acquired at each form level by all students up to and including Form 4. But after five years of curricular confusion I am inclined to think that even that modest portfolio might be too much.

To answer the question in the title of this address, I would have to say that my overall judgment is that the curricular reforms of the last 10 years have imposed enormous costs with very few discernible benefits – that they have taken us backwards and not forwards. Given the apparent lack of thought that has gone into them, this is not surprising. I have little doubt that we will spend much further time and effort over the next decade in unravelling them. How should we go about this?

As I have already indicated, substantially reducing the government's involvement in the curriculum and leaving much more to schools and the professionalism of teachers is part of the answer. But it is certainly not the whole answer if the standard of school teaching and student learning is to increase. We need at least two other policy changes – both highly contentious in today's climate. First, we need independent assessment of the performance of all children at the primary level with publication of school results[21] and, of course, quality examinations at the school leaving levels. Unfortunately, the government appears to have set its face against the former and, in terms of the latter, appears – sufficient details are still lacking – to be about to introduce unsatisfactory compromises between unit standards and traditional examinations.

The second requirement is that parents must be given the ability to choose the curriculum and pedagogies they consider most suitable for their children and the school they think most likely to provide them. In recent years we have seen some increase in the funding of private schools, but it has not been sufficient to halt integration into the government system which has left only a very small percentage of the school population being educated outside that system. These are issues well beyond my present brief, but I wished to make it clear that, as in most policy areas, a single policy instrument will not achieve what is wanted and may even have perverse results.

What is usually wanted for successful reform is a suite of mutually reinforcing policy changes. This is certainly what is required in the school area, and the suite should include reducing government control of the curriculum with a corresponding increase in school and teacher control, providing more reliable information about the relative performance of

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19 According to a recent media report the British government has done just that - abandoned much of the extensive school curriculum introduced some 11 years ago for England and Wales to "enable teachers to use their professional judgment" (*The Weekly Telegraph*, Issue No 408, May 1999).

20 Irwin, MDR (1994), *Curriculum, Assessment and Qualifications – An evaluation of current reforms*, Auckland: Education Forum.

21 The case for national assessment in literacy and numeracy for all children at age 10 and the publication of school results has been well made in 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'*, Auckland: Education Forum, October.

schools and students, and giving parents the ability to respond to the increase in information and to greater curricular and school diversity. At present we appear to be going backwards on some – possibly on all – of these fronts.

**WELLINGTON REGIONAL CHAMBER OF COMMERCE**

# THE EMPLOYMENT CONTRACTS ACT AND THE 1999 ELECTION

**ROGER KERR**
**EXECUTIVE DIRECTOR**
**NEW ZEALAND BUSINESS ROUNDTABLE**

**WELLINGTON**
**2 JULY 1999**

# THE EMPLOYMENT CONTRACTS ACT AND THE 1999 ELECTION

It is, I think, fair to say that most of the major changes made to New Zealand's economic framework over the last 15 years are no longer controversial. The dismantling of fortress New Zealand, open financial markets and a floating exchange rate, the Reserve Bank of New Zealand Act 1989 and the Fiscal Responsibility Act 1994, for example, are broadly supported by most political parties. They will not be major issues in the coming election.

Not so, however, another key element of the framework, the Employment Contracts Act 1991 (ECA). If there is a change of government, the legislation which has governed employment relations for most of this decade will be repealed. To varying degrees, the political parties Labour and the Alliance want to turn the clock back.

The proposed changes will send a strong signal to the international investment community about the attractiveness of New Zealand as a place to invest and do business. With New Zealand's overseas debt currently standing at around 100 percent of gross domestic product (GDP), the importance of any moves that are harmful to the business environment and the economy should not be under-estimated.

Why would the opposition parties want to turn the clock back? To be sure, they were critical of the ECA at the time it was enacted, as were the trade unions and several other groups. But have their criticisms been borne out? Let us take a look at the record.

For a start, there were many predictions of industrial mayhem under the ECA: Council of Trade Unions president Ken Douglas said the changes would lead to "anarchy". What happened? Industrial disruption has reduced dramatically. In the five years before the ECA, annual work days lost through strikes averaged 266,000. In 1998, the figure had dropped to 11,778 – the lowest for 64 years.

Unions also warned that wages would collapse when union privileges were withdrawn and national awards disappeared. What happened? Real wages fell only marginally despite the recession of the early 1990s and they began to rise as the economy grew strongly in the mid-1990s. Average weekly earnings have risen from $564 in May 1991 to $682 in February 1999.

The deputy leader of the Labour Party, Michael Cullen, claimed that the recovery would be "jobless". What happened? Over quarter of a million new jobs have been created since 1991. These are net additional jobs; the increase offsets by a long margin those jobs lost through restructuring and economic change. Unemployment fell from 11 percent of the labour force to 6 percent by late 1996, a very sharp fall by international standards. It could have been down to 4 percent by now had New Zealand maintained the momentum and direction of change.

Michael Cullen and others then complained that the reforms had done nothing for productivity. It would not have been surprising if labour productivity improvements were modest, given the large numbers of previously unemployed and typically low-skilled people entering the workforce. However, gains in capital productivity were likely when more flexible overtime and other working arrangements increased the utilisation of capital. The most recent and comprehensive study of trends in New Zealand productivity by Erwin Diewert and Denis Lawrence, undertaken for the Treasury, finds that after 1993 there was a "productivity surge". The authors state that "This is likely to have been aided by the effects of the labour market reforms of the early 1990s, among other things".

Critics claimed that the changes would lead to 'casualisation' of the labour force and a lack of job security. There is no evidence of an increase in the proportion of workers employed on a casual or non-permanent basis. There has been substantial growth in full-time employment as well as part-time work, which is often preferred by many. The latest Household Labour Force Survey reported that only 7 percent of those working part time would actually have preferred to work full time. A recent AC Neilson survey indicates that over 70 percent of employees are happy with their job security.

Ken Douglas claimed that employers might be happy with a decentralised labour market while the economy was in recession, but would clamour for centralised incomes policies once it began to grow. Despite real annual economic growth peaking at nearly 7 percent in 1994 and averaging around 4 percent in the four years 1993–96, there was no such clamour.

Finally, what about income inequality? The recent Statistics New Zealand study tells a clear story: income inequality grew significantly during the late 1980s due in large measure to rising unemployment and the Labour government's failure to free up the labour market. It stabilised in the 1990s following the ECA and other reforms.

This is a fairly substantial catalogue of errors on the part of critics of the ECA. People like Ken Douglas have simply never understood how labour markets work. I think we are entitled to conclude that those who still want to repeal the ECA are driven not by facts and logic and any overall national interest – including the interests of workers, businesses and the unemployed – but by ideology and vested interests.

What would Labour put in its place? Labour still appears to be dancing to the tune of the Council of Trade Unions, even though barely one worker in five is now a union member. It has based its policy explicitly on draft legislation drawn up by the CTU. The basic thrust of its proposals is to elevate the role of trade unions and collective bargaining. Five changes would be of particular significance.

The first change, which would be of huge importance, is that only unions can be a party to a collective agreement. The right of employees to bargain through an agent of their choice will disappear. At present the majority of collective agreements do not involve a union. This is a blatantly pro-union and anti-worker proposal. For many work sites it will mean de facto compulsory unionism as many employees for practical reasons will feel compelled to join a union.

Secondly, unions will have new rights to initiate negotiations for multi-employer collective agreements. At present only 2 percent of all collective employment contracts cover more than one employer. A union need only serve notice on more than one employer in an industry and all will be obliged to negotiate. Port companies, for example, might be obliged "to make every effort" to negotiate a national ports agreement, even if they had no interest in doing so. Unions will be able to take strike action in support of multi-employer contracts. Thus, as an employer or employee, your business could become involved in a dispute which has nothing to do with your operations or terms of employment. We could see a move back from enterprise agreements to broad industry awards and many more days lost in strike action.

Thirdly, individual employment contracts (IECs) may not be inconsistent with collective employment contracts (CECs). Thus if, as an employer, you have an overtime provision in a CEC you must have at least the same provision in an IEC. Employers and employees would be less able to negotiate the most suitable arrangements on a case-by-case basis.

Fourthly, Labour would introduce so-called 'good faith' bargaining. This is lawyer-talk which would allow a court to impose just about any substantive and procedural requirements on just about any employment relationship. It could, for example, require employers to disclose sensitive commercial information to unions and, where multi-employer contracts are stipulated by a union, to competitors. In the United States a refusal to increase a negotiating offer has been held to be a breach of good faith.

Fifthly, the Employment Court would be given a greatly expanded new role and additional powers. A power to overturn or modify "unfair" employment contracts would mean the Court would become the arbiter of what are reasonable terms and conditions of employment. Appeals of Employment Tribunal decisions could be re-run with full hearings, which would extend appeals from half a day at present to several days. Chief Judge Tom Goddard has been reported as saying that the Employment Court would need 10 new judges (it has four at present).

The CTU's bill contains numerous other changes such as new rights of entry by unions on employers' premises, provision for two union meetings a year of two hours' duration (paid for by employers), and leave for union business. Secondary boycotts would become legal and 'dependent contractors' would be deemed to be employees and come within the scope of the legislation.

The Labour Party maintains that such changes would bring New Zealand into line with International Labour Organisation (ILO) principles. But the ILO's criticisms of the ECA were unfounded. There is nothing in the ECA that discriminates against collective bargaining – it is neither favoured nor disfavoured relative to individual contracts. In its latest report on New Zealand, the Organisation for Economic Cooperation and Development (OECD) stated that "the framework of labour market regulations in New Zealand is sound", although it pointed to the need to modify "cumbersome" personal grievance procedures governing redundancy and dismissals. Too much of the ILO's thinking still inclines towards systems of labour market regulation such as those which characterise many European countries and contribute to their rigid economies and high rates of unemployment.

It should also be noted that Labour's programme includes industry policies, changes to occupational health and safety and a return to statutory monopoly accident compensation arrangements. All these would strengthen the role of unions.

The upshot of all this would be a major transformation of current arrangements – not mere tinkering. It would take New Zealand a long way back towards the bad old days of union domination of workers, industrial confrontation and dysfunctional workplaces. The Alliance, which might influence a coalition government, would go even further: it still harbours a 'class warfare' view of labour relations.

Are Labour's proposals in line with the direction of policy thinking and the lessons of labour market experience in the 1990s? The answer is surely no. The major OECD *Jobs Study* stressed the importance of labour market flexibility to improve productivity and reduce unemployment. The US labour market has shown the rigid European labour markets a clean pair of heels over the past decade. Not only has it created far more jobs but, as it has become tighter, wages for low-skilled jobs have started to rise, contrary to earlier criticisms.

In nearly half the metropolitan areas of the United States, unemployment rates are below 4 percent. Unemployment in the state of Minnesota fell to 2.1 percent in April this year, the lowest ever recorded in the state and the lowest in the country. As *The Economist* put it recently, "In this workers' market, anyone with a measurable pulse and two fingers to peck at a keyboard is employable". Employers are hiring people who were regarded as unemployable five years ago, particularly black youth. Welfare reforms have reduced the incentives to stay out of the workforce. The gains are coming at a time when affirmative action, preferential contracting for minorities and most job training programmes are no longer expanding. Clearly flexible labour markets are proving to be far more powerful forces than government programmes for lifting up disadvantaged groups.

In Europe, by contrast, unemployment remains stuck at nearly 10 percent or more in countries like Germany, France, Italy and Spain. Of the major countries, only Britain is faring better, following the Thatcher government's trade union reforms in the 1980s. A chronic problem in Europe is employment protection regulations – restrictions on terminations and dismissals in particular. These reduce employment, lead to greater and longer unemployment, and slow down the reallocation of labour from declining to growing sectors of the economy. In a document *Europe: The Third Way*, British prime minister Tony Blair and German chancellor Gerhard Schröder recently called for more flexible labour markets in Europe.

Why are the New Zealand opposition parties not taking on board the abundant evidence of labour market experience in New Zealand and elsewhere? There are perhaps three possible answers to that question.

The first is political. Labour seems to be still putting the interests of labour organisations and those they represent, including the public sector unions, ahead of general employee and employer interests, as it did in the 1980s. In particular, the 7 percent of the workforce that is currently unemployed is relatively powerless politically – unions reflect the interests of their employed members.

Secondly, today's Labour Party has little experience of business. Like Ken Douglas, I suspect many Labour politicians understand little about employment. One still hears, for example, claims that a large pool of unemployed suits businesses. But how will businesses be better off if there are fewer people with incomes to pay for the goods and services they produce? Why would businesses be unwilling to hire people so long as their pay rates are justified by their productivity? How many firms in New Zealand or the United States are calling for policies that would increase unemployment?

Thirdly, critics of deregulated labour markets may still harbour views that labour markets are somehow 'special' and suffer from exploitation, monopoly and imbalances in bargaining power. These shibboleths have long since been exploded. If employers have unequal bargaining power, why do we not see a wage rate of, say, $10 an hour being forced down to $9, $8 or indeed anything above zero? The fact that wages have risen under the ECA as workers with particular skills became in short supply should have disposed of this myth once and for all.

Instead of returning to an adversarial view of the employment relationship and reregulating the labour market in ways that will increase strife, New Zealand should be going in the opposite direction. We should be striving for further improvements in our productivity and employment performance. This should involve addressing unsatisfactory aspects of the Employment Contracts Act 1991 and related regulations such as the legislation governing human rights, minimum wages and holidays, as well as getting the country back on course more generally.

There is no reason for New Zealand to tolerate high levels of unemployment. It is nothing less than a scandal that the Maori unemployment rate is now back up to around 20 percent having come down from over 27 percent in the early 1990s to about half that rate by the middle of the decade. Many people seem to believe that full employment is a thing of the past and is unlikely to be achieved again, now or in the future. That belief is nonsense, as the United States is showing today. There is no reason why we should not be looking back in a few years' time on the high unemployment rates of the 1980s and 1990s as an aberration, just as the high inflation years of the 1970s and 1980s are rightly seen as an aberration today.

To boost productivity and employment prospects, the key step required is to establish full freedom of contract in the labour market. The employment market is not complex. It involves ordinary contracts between employers and employees. There is no area in which there is a stronger case for markets and contract law. The fundamental weakness of the ECA is that it did not go far enough to reflect this basic proposition. In particular, it carried over from the old regime a set of personal grievance provisions which are quite inconsistent with the principle of freedom of contract. These provisions, particularly those governing dismissals, have been as harmful in New Zealand as their counterparts in Europe and Australia. As *The Australian Financial Review* put it in a recent editorial "Free to Fire, Firms will Hire":

> The economic case against employment-protection regulation is strong. As with most intervention in markets, it harms the very people it is intended to benefit. Provisions such as statutory notice periods, severance pay entitlements and compensation for unfair dismissal raise the cost of sacking workers. As a result, firms hit with falling demand, the need to cut costs or adopt new technologies, or those simply facing workforce disciplinary problems, bear higher costs when they make economically necessary dismissals. In the next recovery, they will anticipate these costs and hire less labour.

The remedy to this problem is simply to make the inclusion of personal grievance provisions in contracts a matter of voluntary negotiation. Such provisions are effectively paid for in any case by workers in the form of lower wages or other conditions of employment. Some workers will prefer them, but others will prefer the higher wages.

Those who look back on the 1950s and 1960s in New Zealand with nostalgia might reflect that this was the employment law prevailing at that time, before concepts of wrongful and unjustifiable dismissal were introduced. Was that period characterised by persuasive unfair and exploitative treatment of workers? I do not think so. Rather, it was characterised by virtually full employment, so that if some workers happened to be wrongfully dismissed, they were quickly able to find other jobs. No human relationships are perfect, and employment relationships are no exception. There can be bad employers and bad workers. But open labour markets allowing workers to quit unsatisfactory jobs and employers to fire unsatisfactory workers are the greatest protection for both parties against individual injustice. Other protections can be negotiated by contract, if both parties so wish.

The other major departure from normal contract law in the employment area is the continuation of the specialist Employment Court. We have argued that the work of the Employment Court should be transferred to the normal court system, and that the principles of contract law which underpin the ECA should be invoked generally. Mandatory provisions, such as the statutory benefit rates for accident compensation and the prohibition on setting retirement ages contained in the Human Rights Act 1993, also negate the benefits of voluntary contracting and should be removed. And in the public sector we should be moving away from contracts such as the recent teachers' agreement which still contains such archaic features as the right to salary deduction of union fees and no ability to establish direct employment arrangements at the school level.

Let me conclude by noting that the labour market is one of the most important markets in a modern economy. It accounts on average for around two-thirds of firms' costs of production and is the main source of household incomes. If the labour market is not working efficiently, the performance of the whole economy will be set back, and everybody's living standards will suffer.

Some people, including even the Treasury, seem to be puzzled that New Zealand is not doing better as a result of its economic reforms. I suggest there is very little mystery. The main reforms took place many years ago and they have delivered their expected benefits. The economy was put on a much sounder footing and appears capable of growing at perhaps 3 percent a year on a sustainable basis, a substantial improvement on our past performance. We have also made major gains on inflation, unemployment and public debt. But more recent trends – ever-increasing government spending and unjustified social, labour market and environmental regulation – are deterring mobile capital and labour and dragging down the rate of economic growth. There is no reason to think that the gains should have been greater than we have seen. Why would anyone expect a country that has fallen to twentieth position in the rankings of international competitiveness – close to the bottom of the OECD group of countries – to be doing any better? If we aspire to the high productivity, high income and high employment performance of a country like the United States, we must adopt comparable high quality policies – indeed superior policies that really make us stand out, given our inherent disadvantages of size and location.

It follows that in the labour market area we can ill afford to go back down a path of reregulation and union involvement, even if it stops short of national awards and explicit compulsory unionism. It is paradoxical that those who claim to care most about the unemployed and people on low incomes continue to promote policies that keep people out of work and widen income inequalities. Most countries today are trying to free themselves from centralised arrangements and introduce greater flexibility. New Zealand has been moving in the right direction and should go further. Unemployment, and labour market performance generally, is a matter of choice. If we choose badly, by opting for or staying with dysfunctional labour market arrangements, we have only ourselves to blame.

**PLIMMERTON ROTARY CLUB**

# WHAT PARENTS SHOULD KNOW ABOUT EDUCATION

**ROGER KERR**
**EXECUTIVE DIRECTOR**
**NEW ZEALAND BUSINESS ROUNDTABLE**

**PLIMMERTON**
**17 JUNE 1999**

# WHAT PARENTS SHOULD KNOW ABOUT EDUCATION

My topic today is school education. In spite of all the talk of 'reforms', our schools sector is, in my view, still one of the least reformed parts of our society. And what reform there has been has often been deeply flawed. We need to do much more – and differently. I want to explain why I hold these views.

For many years New Zealand has been complacent about the performance of its schools. Sure, there were recognised problem areas. For example the performance of Maori children was well below that of the rest of the population. And there was an uncomfortable feeling that we were not all that hot at maths. But these areas were seen only to need 'tweaking' – not serious reform – and, of course, lots more money, and the problems would then go away. Our schools and our teachers are, after all, the best in the world. Or at least that has been the rhetoric.

My perception is that for some years now this complacency has been wearing very thin. The general population has been concerned, as evidenced by many comments in the media. What have been some of the symptoms?

First, our standard of grammar has been a particular cause of much concern. A few years ago Emeritus Professor Wallie Clark of the University of Canterbury wrote of the 30 years of neglect and depreciation of the rigorous teaching of English which has resulted in university students who are unable to get their thoughts down on paper.[1] The process involved the rejection in schools of discrimination on the basis of ability and the introduction of social promotion, and teaching across wide ability ranges. Difficult subjects, including English, became optional. Accreditation allowed disclosure of incompetence in English to be avoided if achievement in other subjects was passable. Professor Clark went on to note that the situation worsened as the products of the changed system became teachers themselves and, having little understanding of syntax and grammar, simply passed on their ignorance to the next generation of students.

I noted a letter in *The Dominion* a few years ago from somebody who had, presumably, missed out on grammar at school and who wanted to make good the deficiency in later life.[2] He had rung all the local secondary schools and the Correspondence School in the hope of finding a tutor. The typical answer was "We don't have staff who understand grammar, let alone teach it". Well, at least the answers were refreshingly honest.

Should this loss of grammar worry us? George Orwell was clear that it should.[3] The English language, he said, "becomes ugly and inaccurate because our thoughts are foolish, but the slovenliness of our language makes it easier for us to have foolish thoughts". In other words, it is a two-way process: poor language skills lead to poor thinking which further impoverishes language.

What about reading? In recent years empirical studies have shown that while New Zealand primary children do well internationally in reading, we also have an unusually long tail of poor performers. That our poor levels of English teaching at school is no new phenomenon is evident from a recent report on adult illiteracy which, in effect, measured the outcomes of several decades of New Zealand education.[4] Only about half our adults were found to operate at a literacy level considered necessary for meeting the demands of everyday life (in Sweden about three-quarters were found to operate at this level). Of

1 *The Press*, 2 November, 1994.
2 *The Dominion*, 21 January, 1995.
3 George Orwell, 'Inside the Whale and other Essays'.
4 Ministry of Education, *Adult Literacy in New Zealand*, Ministry of Education, Wellington, undated (probably 1997).

particular concern was the high proportion – about one in five – of adults with very poor literacy skills.

Then there is general knowledge. We do not seem to be teaching our children very much actual knowledge. There is a natural and proper concern to ensure that children do not grow up with an obsession with facts to the exclusion of everything else. Thomas Gradgrind, the schoolmaster in Charles Dickens's *Hard Times*, insisted that: "Facts alone are wanted in life. Plant nothing else, and root out every thing else". We would share Louisa Gradgrind's concern for the "graces of the soul", "the sentiments of the heart" and all the other "inappreciable things that raise [life] from the state of conscious death". In more down-to-earth language, theory, analytical ability, scientific method and aesthetic appreciation matter too. But in New Zealand this seems to have mutated into a belief that we do not need facts at all.

A survey of students at the University of Canterbury conducted a year or so ago revealed the most alarming ignorance among our top students about the world around us. Some 10 percent of those surveyed thought that the sun rises in the west, 60 percent could not identify Gutenberg as having made the first printing press (some thought George Gershwin was the inventor), and a quarter thought the Vietnam war preceded the Korean war. Denis Dutton of the University of Canterbury suggested that this level of ignorance among our top students reflects a successful attack by the politically correct against 'traditional' notions of memorisation and recitation and by those who decry anything that lacks vocational relevance.[5]

Where do we stand on literature? I suspect this ignorance about general knowledge would apply equally well to the classics of the English language. Agnes-Mary Brooke, a commentator on social and educational issues, reported on a small survey she conducted among students from different faculties at the universities of Otago and Canterbury.[6] It emerged that many students regretted that they had been taught so little of substance in English classes at school. They had had little or no exposure to what, according to Professor Karl Stead, should be the crown of English studies at school, that is:

> ... the encounter with literature, which offers the best, richest and most exciting examples of language use, the folk stories of our inherited European culture as well as the tales of our own settler and post-colonial experience – a fund of wisdom, a storehouse of fact, and a range of experience beyond the powers of any one person to live through in many lifetimes. The very best of poetry or fiction exposes readers, as often as they care to open a good book, to the influence of minds and sensibilities finer, more developed, richer, than they are likely to meet more than once or twice, if ever, in real life.[7]

A striking contrast to this view of English literature can be seen in the proposal for an English department course at Massey University on Feminist Readings of the Media.[8] Apparently Rachel Hunter, Marilyn Monroe and Elle Macpherson were to be the subject of lectures in a course called: The Female Star as a Semiotic Site. An explanatory paper said that the course "will use prevalent theories of textual production, interpretation and consumption to analyse the significance of female representation in textualities featuring women as well as in those produced and/or consumed by women". Students were to "study television sitcoms and drama, popular romance and film". I do not know whether the course went ahead, but it is amazing to me that it could even be contemplated by a publicly funded state university. It may cater for those brought up on a diet of Neighbours

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5 *The Otago Daily Times*, 17 October, 1997.

6 *The Dominion*, 28 July, 1995.

7 Education Forum, 1994, *English in the New Zealand Curriculum: A submission on the Draft*, Education Forum, Auckland, April. Professor Stead was the principal author.

8 Reported in the *New Zealand Herald*, 5 May, 1995.

and Shortland Street but surely not for those who were nurtured on the more substantial fare of, say, Shakespeare and Milton.

But English and the humanities are not the only areas of concern – science and maths are others. A study of the mathematics ability of students entering the primary teachers training programme at the Auckland College of Education revealed the most alarming mathematical incompetence among those destined to teach our children.[9] Michael Matthews, then Professor of Science Education at Auckland University, reported that the tests were "pathetically simple" – being pitched at an upper-primary or lower-intermediate level of competence and that "in order to lessen supposed test anxiety and novelty effects, a version of the test was sent to all prospective students some weeks before the College test ... and students who wished to could bring relatives to sit with them during the test".[10]

The tests were indeed astonishingly easy. However, 19 percent of students could not measure the length of a pencil placed against a ruler with its end on the zero mark, and when the end was placed on the 2 cm mark, this figure jumped to 27 percent. Thirteen percent could not work out the cost of an item with goods and services tax (GST) at 10 percent and when the test required reworking the calculation with GST at 12.5 percent the error rate jumped to a staggering 41 percent. Forty percent did not know how to work out the price per litre of petrol given that 4.15 litres cost $3.69. I would stress that these results are of students who had gained entry to a teacher training college and who are, in many cases, now passing on mathematics to the next generation of New Zealand school children.

It might of course be argued that the students' mathematical ability improved very significantly during their time at training college. However, Matthews was not so sure. One student who scored low in the pre-entry maths test and yet scored a distinction at the end of her first year was asked to explain the disparity in her grades. She said:

> The score [in the entry test] doesn't surprise me really – if I had been taught these things I would have been able to do them. I was doing the test on my own – there was no one there to ask questions of, to help me out, to explain the questions to me if I didn't understand what to do.

Professor Matthews noted that this student's comments "invite the thought that maybe the [college's] first year mathematics papers are easier than the entry test. If so, there is a complete trivialisation of tertiary education occurring in New Zealand".

The results of the International Association for the Evaluation of Educational Achievement (IEA) studies of science and maths performance, reported in 1997, only confirm the concerns about our poor maths performance at primary level.[11] The studies tested more than half a million children in 26 countries. Our Standard 2 and 3 children were found to be "well below" the average among participating countries in maths and slightly above average in science. Form 2 and 3 children were "mediocre at best" in maths and Form 3 science students only slightly above the international median. The study said many New Zealand teachers had a poor grounding in maths and science and that the colleges' minimum requirements for studying the subjects and how to teach them were "worryingly low" – after Professor Matthews' comments this should have come as no surprise. It also said that New Zealand teachers might provide too much "fun" maths and science and not enough challenging activities, and suggested there was too much reliance on calculators.

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9 Buzeika, A (1993), 'A Study of Entry Levels and Progress in Mathematics of Primary Teacher Education Students at Auckland College of Education', thesis submitted in partial requirement for the Diploma of Mathematical Education at Auckland University.

10 Matthews, M (1995), *Challenging NZ Science Education*, Dunmore Press, Palmerston North, pp 57–64.

11 The following comments are taken from the report by John Gerritsen in the *New Zealand Education Review*, 11 June, 1997.

For me, the problems of New Zealand education, despite our habits of denial, were encapsulated in two statements by recent ministers of education. Wyatt Creech told a Post Primary Teachers' Association (PPTA) principals conference in 1996: "The fact is that New Zealand has a world class education system – other country's (*sic*) envy us". And, almost as if to underline the problems with literacy, Nick Smith proudly announced the results of the literacy taskforce earlier this year, emphasising that it was the work of a group "compromising (*sic*) mostly principals and teachers". To be fair, the problem may not be with the ministers; it is more likely to lie with the products of the education system that find their way into the bureaucracy and ministers' offices.

It would be nice to be able to say that these deficiencies have been fully acknowledged and that reforms enacted or in train will effectively deal with them. But I cannot hold out this hope. In fact in some ways I think recent reforms will make matters worse.

Consider the curriculum reforms that have been progressively introduced since 1993 when the New Zealand Curriculum Framework was published. The main change was to specify curricula in terms of outcomes and not content. The government confirmed in a recent Green Paper that "there has been a shift to look directly at student outcomes: how well are students doing".[12] On the face of it, this sounds very sensible. Surely it means we could expect to see outcomes set in terms of what children actually know, which means that the content of what they should know, and the context in which they develop skills, must be specified? Surely we could expect the new Social Studies curriculum to address the appalling ignorance of general knowledge and the new curriculum for English to introduce much-needed precision and rigour into the teaching of English. Unfortunately, not so.

What we often find, if we browse through these new curricula, is mush. There is very little recognisable content. For example, here are some objectives from the new English curriculum in the strand for "expressive writing":

Level 1: write spontaneously to record personal experiences

Level 3: write regularly and with ease to express personal responses to different experiences and to record observations and ideas

Level 5: write regularly and confidently to respond to a range of experiences, ideas, observations, and texts, developing a personal voice

Level 8: use expressive writing regularly, fluently, and by choice, to reflect on, interpret, and explore a wide range of experiences, ideas, feelings, and texts, expressing complex thoughts in a personal voice.

Several things occurred to me as I read through these objectives. First, they are full of adverbs like "regularly", "confidently", "fluently" and so on which are capable of a wide range of interpretation. How often does a child have to write in order to reach the "write regularly" requirement? How fluent is "fluent"? Yet we are also told that learning outcomes are to be so "clear" that students' achievement can be assessed against them.

Secondly, there is nothing at all about writing well – about good sentence structure, grammar, spelling and such like. When, for example, should a child learn about commas and semi-colons and apostrophes? How many words should a child know how to spell correctly at the various levels? We are not told.

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12 Creech, W and Donnelly, B (1998), *Assessment for Success in Primary Schools*, Ministry of Education, May, p 7.

Thirdly, progress through the levels depends on developing such things as regularity, confidence and fluency – not on increasing precision, accuracy and style. Elsewhere there are very general references to grammar, syntax, and the "conventions of written forms" but we are not told what they are or when they should be introduced into the classroom. All this is extremely disappointing. We cannot look to the new curriculum to remedy our national deficiency in the English language.

Nor will it, of itself, do much to restore appreciation of our cultural inheritance. There is a vague reference to "texts of established critical reputations" (which could cover just about anything), but the main emphasis is not on literary merit but on the importance of children reading from a range of literature "balanced" in terms of local and overseas origin and ethnicity of author – again all very discouraging.

Last year the government established a taskforce to advise it on literacy at the primary level and how to achieve the literacy objective in its goal that "By 2005, every child turning nine will be able to read, write and do maths for success". The taskforce reported in April and many of us looked to it to do something to redress the lack of rigour in the English curriculum. But it is a disappointing document. I would have expected the taskforce to establish the symptoms of poor literacy performance, investigate and identify the causes, evaluate the possible solutions, and then come up with conclusions and recommendations consistent with the analysis. But the report is full of banalities and ducks all the tough issues. According to a media comment, a key point in the report was that the "system doesn't need changing but tweaking or 'intensifying' in some areas".[13] It is the educational equivalent of saying that we can earthquake-proof a building by applying another coat of paint.

Another tentative, but possibly useful, initiative also seems likely to come to nought. In May last year the government put out a Green Paper on assessment in primary schools. It proposed a rather weak set of assessment methods in the hope, presumably, that this would lead to a marked improvement in children's learning. The most contentious proposal was that all primary children should take externally set and marked tests in English and maths at certain stages. However, the results were to be reported in an obscure way making it difficult to compare the results of individual schools; indeed the paper explicitly said that the government would not publish 'league tables'. Unfortunately, the new minister of education has endorsed the anti-league table stance of the Green Paper, and education officials and providers have raised questions about whether there will be external assessments at all.[14] We await government decisions, but the outlook is not promising for those who look for some clear, externally referenced tests in core subjects such as English and maths so that parents can know how well local schools and their own children are doing against national benchmarks. Interestingly, the responses from some 22,000 parents indicated that "they had a thirst for more information about how well their children are doing".[15] They are going to be disappointed.

I conclude that we have some serious deficiencies in our schooling systems that are now increasingly acknowledged. However, we are simply not searching for those causes of the problems which are capable of being addressed by the government and schools. They must involve the selection, training and employment of teachers, teaching methods, curriculum specification, assessment, and school governance and management. Instead we have been messing about at the margin – the tough but ultimately critical issues, such as how to get rid of poor teachers and attract and retain good ones, are off-limits. And it is the same with external assessment and anything else that might question or challenge the effectiveness of schools or the competence of teachers. The ministry will not contemplate any change to current curriculum reforms that, in my view, are set to make the situation

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13 *New Zealand Education Review*, 16 April, 1999.

14 Nick Smith, 1999, 'The Education Agenda – Priorities for '99', Rotorua, 22 March.

15 Frances Kelly, a senior manager of the Ministry of Education, reported in the *Otago Daily Times* of 13 April, 1999.

worse. The results of the taskforce on literacy and the Green Paper on assessment seem unlikely to do other than give bureaucrats more work. It is, I regret, a gloomy outlook. Where should we be going?

The first point is that we need a new way of thinking about schooling – not simply tackling bits and pieces at the margin. The underlying assumption is still that the system is fine and more funds and additional tweaking are all that is required. We have been spending and tweaking for decades, yet the problems persist. Why? I suggest the basic problem is that we are trying to run a highly complex, geographically decentralised schooling system by central edict from Wellington. Inevitably the interest groups at the centre, in the education bureaucracies and the teacher unions, influence the outcomes of policy debates – indeed determine what is open for discussion. We now have a system that, under the Picot reforms, was meant to be highly decentralised and provide some parental choice of school, yet is increasingly regulated from Wellington. Parents have some voice on boards of trustees but no real powers – and virtually no powers of exit, that is, of removing their children from a failing school, unless they are wealthy enough to fund additional transport costs and private school fees.

I suggest the government should focus on what it alone can effectively undertake. In the curriculum area this might be a core curriculum for the primary and lower secondary sectors. The government should ensure the provision of good information to parents about school performance and their own children's achievement relative to national norms, which at the primary level would require externally set and marked assessments in core areas such as English and maths. All schools – government and private – should be financed on a similar basis to allow parents choice of schooling for their children. State schools must be given the freedom to thrive and grow, and this must include freedom to contract with teaching staff subject only to general employment law. Equally, failing schools must be closed or taken over by successful ones. Schools must be allowed to innovate.

This is hardly a radical prescription. Consider, for instance, what is going on in Britain. As *The Economist* put it recently:

> In response to [its] problems, Britain's education reforms have tried to be much tougher about discriminating between successful and failing schools. League tables of schools, based on exam results, are published every year. The government has begun to close failing schools and is encouraging private-sector managers to get involved. Within schools 'progressive' teaching methods are being discouraged, and there is more of a focus on basic literacy and numeracy. Mixed-ability teaching is being discouraged in favour of streaming by ability. Measurable progress is being made.[16]

It is interesting that it is a Labour government that is pushing ahead with real reforms that must put it seriously at odds with its supporters in the teacher unions. We share many of Britain's problems, yet there is very little sign here, under a government with few political links to the unions, of the determination that Britain is showing in tackling them. And Britain's reforms, radical as they may already seem to many New Zealanders, will, I think, fail unless they are followed by further reforms such as attaching funds to pupils, not schools, thus giving successful schools the incentive and opportunity to expand. In New Zealand we have a long way to go, and the tragedy is that, although the need is staring us in the face, we do not yet seem to be prepared to acknowledge the importance of making the journey.

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16 *The Economist*, 10 April 1999, p 18.

# SOCIAL POLICY

**TAUPO CHAMBER OF COMMERCE**

# EQUALISING INCOMES OR REDUCING POVERTY: WHICH BASIS FOR WELFARE POLICIES?

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# EQUALISING INCOMES OR REDUCING POVERTY: WHICH BASIS FOR WELFARE POLICIES?

We know little about the distribution of wealth and income in New Zealand. There are, for example, no official statistics of the overall wealth of individuals or households. Although the distribution of income has been the subject of several studies over the past 30 years, many questions remain unanswered.

A recent study by Statistics New Zealand, *New Zealand Now: Incomes*, provides the most up-to-date information available on this topic. It is a competent and useful piece of research. The purpose of this talk is to summarise and comment on some of the key findings of this report, and to examine whether equalising incomes or reducing poverty should be our prime concern in designing welfare policies.

Statistics New Zealand correctly acknowledges that a country's economic performance has a significant impact on the standards of living of its citizens and on the distribution of income. It is economic growth – not redistribution of income – that facilitates higher personal consumption and better education and health for all. A high-income, high-growth country also has greater scope to alleviate hardship among people on low incomes than a low-income, low-growth country.

The study reviews New Zealand's lacklustre economic performance since 1960. In that year New Zealand's gross domestic product (GDP) per capita was 32 percent higher than the average for the Organisation for Economic Cooperation and Development (OECD) countries. By 1993 it had slipped to 11 percent below the OECD average and our ranking had fallen from fourth to nineteenth out of 24 OECD member countries.

There is no mystery about the policies that lead to high per capita incomes. Economic growth is fostered by upholding private property rights, maintaining stable prices, implementing prudent budgetary policies, adopting outward-looking trade policies and open markets, and keeping tax and regulatory burdens low.

The Labour government between 1984 and 1988 and the National government in 1990 and 1991 made commendable progress in implementing such policies. More recently, the quality of economic management has slumped. As a consequence, our annual rate of growth has been slowing since mid-1994 and was negative in 1998, and unemployment has climbed back to over 7 percent of the labour force.

Statistics New Zealand's study focused on the distribution of real income (that is, income adjusted for inflation) in the years ended March 1982, 1986, 1991 and 1996. Several categories of personal income (such as wages and salaries, market income and disposable income) and household income (adjusted for size and composition) were examined.

Income generated by personal effort is by far the most important source of individual and household income. In 1996 wages and salaries accounted for two-thirds of personal income from all sources, including welfare benefits. Income from capital is quite small.

The distribution of income was found to have become "substantially" more unequal between 1982 and 1996. The results were broadly similar for all categories of income because of the influence on the findings of changes in the distribution of wages and salary income. As expected, the study shows that disposable income is considerably more equally distributed than income gross of tax and benefits.

The findings differ, however, among three sub-periods. The distribution of income was broadly stable between 1982 and 1986, and again between 1991 and 1996. The change to a more unequal distribution of income mainly occurred between 1986 and 1991. The Labour Party was in government for most of this period.

The period from 1982 to 1986 covers the start of the reforms. The failure of the Labour government to reform the labour market accentuated the fall in employment, particularly of young males, and was a major factor in the sharp rise in unemployment that occurred between 1986 and 1991. Unemployment is almost always a dominant factor behind poverty and a less equal distribution of income. The number of welfare beneficiaries of working age grew from about 100,000 in 1982 to over 300,000 in 1991. More than 80 percent of that increase occurred between 1986 and 1991.

An article of 10 April, 1999 in *The Economist* discussed the broad economic strategies adopted by several countries, including New Zealand. While *The Economist* claims to have been "a big fan" of the policies pursued by New Zealand, it states that their "bad point" is "a big increase in inequality". However, the *failure* to tackle impediments to employment and the problems of welfare dependency may well do more to explain the less even distribution of income between 1986 and 1991 than the reforms that were *actually* implemented.

The change in the distribution of equivalent household disposable income between 1986 and 1991 reflects a large growth in the share of income earned by households in the top two income deciles and a reduction in the relative income of middle-income households. The share of disposable income attributable to the bottom fifth of households, which are almost entirely dependent on government transfers, declined slightly between 1986 and 1991. However, their spending was much higher than their disposable income – an important and not uncommon finding of such studies, on account of factors such as unmeasured sources of income. The study confirms that the relative position of low-income households was largely protected by welfare arrangements. These results are consistent with an analysis by George Barker that was published by the Institute of Policy Studies in 1996.

Statistics New Zealand did not explain why the reported share of disposable income attributable to households in the top decile increased by a quarter between 1986 and 1991. A number of possible reasons suggest themselves. Most obviously, the margin for higher skills may have increased. Such an increase has been a worldwide phenomenon and helps explain the strong growth in enrolments in tertiary education. The opening of the economy to international competition may also have led to higher salaries for some people. Another possible factor is the growth in two-income households where both incomes are above the average. Despite these increases, New Zealand still stands out as having quite low incomes at the top end, relative to countries such as Australia and the United States.

The reduction in the top marginal rates of income tax in October 1986 and October 1988 significantly increased the disposable income of middle- to high-income earners. However, it does not directly account for the rise in the gross income of high-income earners. One likely explanation is that the reduction in tax rates, coupled with other tax changes, encouraged people to earn more gross income and to reduce tax planning activities, such as the retention of income in private companies, aimed at avoiding or evading tax.

Another possible explanation for the increase in the gross income of high-income earners relates to the fact that following the introduction of fringe benefits tax in April 1985, many firms 'cashed out' such benefits. Fringe benefits were not included in the study. Thus the switch from fringe benefits to salaries will have boosted the reported gross income of many people, even though their effective income may not have changed.

These tax changes affected people on higher incomes the most for the simple reason that they face the highest marginal tax rates and pay the most tax. Households in the top decile by market income paid an average of $39,200 in personal income taxes in 1996. Households in the bottom four deciles received substantially more income by way of government transfers than they paid in taxes.

What does the study tell us about poverty, as opposed to changes in the distribution of incomes? Between 1982 and 1996, according to Statistics New Zealand, there was no increase in the proportion of individuals or households with an income of less than 50 or 60 percent of median disposable income. On the basis of these poverty benchmarks, between 6 percent and 12 percent of households were in poverty over the period.

These measures of poverty are similar to measures used by Stephens, Waldegrave and Frater in an article published in the *Social Policy Journal of New Zealand* in December 1995. Using a benchmark of 60 percent of median disposable income, the latter found that the percentage of households in poverty fell from 13.7 percent to 10.8 percent between 1983/84 and 1992/93. At a benchmark of 50 percent, poverty was stable at 4.3 percent of households. The period examined did not reflect fully the economic recovery that started during 1991. Nevertheless, the study suggests that fewer households were in poverty than reported by Statistics New Zealand. *Neither study suggests a rise in reported poverty since the reforms began*.

The Statistics New Zealand study contradicts three claims that have frequently been made. First, the claim that the rich are getting richer *while the poor are getting poorer* is simply not true. People on high incomes have increased their share of total disposable income while middle-income earners suffered a significant loss of income share. However, there was no significant change in the share of income of low-income households. Had the momentum of the reform programme been maintained, it is highly likely that all incomes would have been higher by now and fewer people would be dependent on welfare benefits.

As an aside, it is worth noting that, although we do not have a long-term statistical series, incomes have probably become *more* evenly distributed over the long run. Brian Easton's analysis of individual tax data, for instance, suggests that incomes became more equal between 1953 and 1976. The same could also be expected to be true for the distribution of wealth.

Secondly, the study refutes the claim that people on low incomes bore a significant fall in their real disposable incomes between 1991 and 1996, as had been predicted when benefits were reduced in April 1991. The average real income of the bottom decile fell by 1.75 percent while that for the second decile was unchanged.

Thirdly, the claim that low-income households were badly affected by the introduction of GST in October 1986 is not borne out by the study. This is no surprise. Benefits were increased, and family support and the guaranteed minimum family income scheme were introduced to fully compensate low-income households for the effect on prices of GST.

In evaluating changes in the distribution of income, Statistics New Zealand relies mainly on the Gini coefficient. This measures the extent to which the actual distribution of income differs from an equal distribution of income – for example, when 40 percent of the population earns 40 percent of total income.

The Gini coefficient is, however, a deficient measure. For instance, a reduction in the income of the highest earners with no change in the income of any other group would be reported as a desirable change in the distribution of incomes.

The Gini coefficient only makes sense as a measure of inequality if envy about high incomes is an equally valid motivation for redistribution as compassion towards people facing hardship. Most people would balk at the notion that envy of the blind for the sighted ought to be rectified by destroying the vision of those who can see. Envy is an unacceptable basis for public policy, just as it is usually regarded as an unacceptable basis for ethical personal behaviour.

This leads to a broader criticism of many analyses of income distribution. Explicitly or implicitly, they tend to assume that the goal should be to equalise incomes. A move toward a more equal distribution of income is described as desirable, whereas a move in the opposite direction is said to be undesirable. The implicit goal is for all people to receive the same level of income regardless of their preferences, age, ability and work effort.

I submit that a goal of equal incomes, either as a means to an end or as an end itself, is a misguided one for any society to pursue. As Aristotle noted long ago, equalising the amount of income people possess will not equalise their well-being because income is a very imperfect measure of welfare. Observed income reflects not only innate abilities but also the myriad of choices that people make. Some people voluntarily forgo income to have more time for leisure activities, to rear children, to further their education and training or to work in their preferred occupations.

Redistribution of income ought not to be about achieving equality but about displaying compassion for fellow human beings who are in hardship and cannot help themselves. A compassionate concern for people who are unable to afford even the minimum material essentials of life should make us very concerned about deviations of income – or, more importantly, spending power – below some minimum acceptable standard. It should not make us concerned about the distribution of incomes or spending *per se* and, in particular, about variations in incomes among people whose income is well above the minimum. A danger we face as a nation in having an unhealthy preoccupation with high incomes is the loss of talented and entrepreneurial people seeking better opportunities elsewhere. An increase in the top personal tax rate would exacerbate this problem.

Relative poverty can only be reduced by raising the income of those who are judged to be in poverty at a faster rate than that of other groups. A doubling in everyone's income, for example, would have no effect on the reported level of poverty according to a relative poverty standard.

An absolute income or expenditure threshold, on the other hand, focuses debate on the explicitly identified commodities and expenditure patterns that are necessary to avoid hardship. It is likely to show substantially less poverty than that reported in the studies discussed earlier. An absolute standard recognises that an increase in real income reduces poverty. This is simply common sense.

The 1972 Royal Commission on Social Security was responsible for a shift from an absolute to a relative standard in setting benefit levels. This was a step in the wrong direction. The average New Zealander can relate to the idea of a safety net which ensures that fellow citizens are not deprived of food and shelter. I believe people are less comfortable with a concept of redistribution based on 'keeping up with the Joneses' in owning, say, one or more telephones, microwave ovens, television sets, videos or cars.

The poor will always be with us, especially if we measure poverty on a relative scale, but the same people are not always poor. People's incomes change markedly over time as they move between education, part- or full-time work, different jobs and so forth. One recent New Zealand study showed that almost half those on welfare benefits in June 1992 were off benefits a year later. Another showed that a quarter of the taxpayers in the bottom income quintile moved to a higher quintile one year later.

Greater emphasis should be placed on individual and voluntary community responsibility to assist people facing hardship, with the government providing a safety net of last resort. The government usually cannot compete with friends, families and voluntary organisations as a means of expressing compassion effectively. As David Green observed in his book *From Welfare to Civil Society*, published by the New Zealand Business Roundtable in 1996, government welfare programmes "have tended to impair human character, above all because they have undermined the older ethos of 'community without politics'".

In a follow-up study *Towards Personal Independence and Prosperity*, also published by the Business Roundtable, Jim Cox showed that New Zealand's welfare arrangements are more generous and place fewer obligations on beneficiaries than Australian arrangements. As a consequence we have proportionately more people dependent on welfare.

If we are serious about helping the less fortunate, we must look beyond static analyses of income distribution and shift the focus to broader policies that raise incomes, create jobs, promote individual responsibility and reflect compassion for those facing hardship. Foremost among these are:

- a return to a coherent medium-term economic growth strategy to raise incomes: only a rising tide can lift all boats;

- the removal of obstacles to free contracting in the labour market, including the Employment Court and statutory minimum wages. There is no reason why New Zealand should tolerate less than full employment. A well-functioning labour market operates like a vacuum cleaner, sucking low-skilled and other disadvantaged people into the workforce. Very few people of working age who work full time, even on low wages, are among the poor;

- a reduction in the levels of government spending relative to GDP, allowing tax reductions which will enable more people to become self-sufficient. Middle-class welfare should be substantially cut back;

- a concerted attack on low education standards, principally by eliminating the virtual state monopoly on education;

- allowing the private insurance market to play the main role in covering insurable risks such as accidents and sickness;

- placing stronger reciprocal obligations on able-bodied welfare recipients to try to become self-supporting, and introducing time limits on benefits as in the United States;

- insisting on greater parental responsibility to provide for children in the event of marriage breakdowns; and

- a larger role for the voluntary sector and private charity to assist those in hardship, with the government providing a back-up safety net.

The impact of such a programme on income differentials cannot be predicted with confidence, although in the long run I believe the historical trend towards a more even distribution of income would reassert itself. What can be said with confidence, however, is that the programme would lift many more people out of poverty, and that, in my view, should be much the more important priority.

**ACT NEW ZEALAND WEBSITE**

# THE PARADOX OF WELFARE

**APRIL 1999**

# THE PARADOX OF WELFARE

Here is a paradox. Two generations ago when state welfare was significantly expanded in many Western countries (including in New Zealand under the Labour government of Michael Joseph Savage), average living standards were far below what they are today. Material progress has vastly improved health standards, education levels and economic opportunity in all advanced countries.

The pioneers of the modern welfare state intended it to cater for a small proportion of the population who needed help, mainly on a temporary basis, during their lifetimes. They saw it as withering away as living standards rose.

But what has happened?

Far from withering away, the welfare state has expanded enormously. Under Savage, government spending as a share of gross domestic product (GDP) was around 18 percent; today it is twice that proportion, and around 80 percent of it goes on social services. Spending on social welfare remains close to its all-time high, despite policy changes and New Zealand's better economic performance in the 1990s. Between July 1992 and May 1996, 930,000 different people received an income-tested benefit – an estimated two in every five people of working age.

What has gone wrong? Much could be said, but three points are worth making:

- Much of the increase in national income has been absorbed by the state; tax rates have gone up dramatically and average disposable incomes have risen much more slowly. Often both parents in a household have been forced to enter the workforce to make ends meet.

- Increased regulation of the labour market has made it less flexible, leading to much higher levels of unemployment. Despite recent reforms, restrictions on hiring and firing are tighter than ever, discouraging job creation and excluding people who are most at risk of being on welfare from getting a job.

- Much higher levels of welfare benefits (including pensions) and fewer restrictions on eligibility have increased the attractiveness of welfare relative to work, and discouraged savings.

In addition, much of the increased spending (eg on pensions and higher education) has gone to better-off groups ('middle-class welfare') and private welfare mechanisms (insurance and charity) have been crowded out.

Internationally, there is now a growing consensus that these trends must be reversed – not only the fiscal costs but also the costs of broken families, blighted lives, crime and other social pathologies are intolerable.

The United States has shown that there is far more room to drive the welfare rolls down than anybody believed until recently. The trends clearly owe more to changes in welfare policies than to the strong economy – the welfare caseload actually grew by 13 percent during the Reagan boom. Little evidence of hardship has surfaced.

A strategy for dealing with welfare dependency in New Zealand must focus on much wider issues than cutting welfare benefits – there is only limited scope for cutting most benefit levels further. Key elements must include:

- the restoration of the sound policy framework which was generating high rates of economic growth in the mid-1990s. Growth is the key to sustained prosperity – only a rising tide has the capacity to lift all boats;

- the removal of obstacles to free contracting in the labour market, including the Employment Court and minimum wage restrictions. There is no reason why New Zealand should tolerate less than full employment. A well-functioning labour market is like a vacuum cleaner, sucking even low-skilled and other disadvantaged people into the workforce, as the United States is demonstrating. Very few people who work full-time, even on low wages, are poor;

- falling levels of government spending relative to GDP, allowing tax reductions which will enable more people to be self-sufficient. Middle-class welfare should be substantially cut back;

- an attack on low education standards, principally by eliminating the virtual state monopoly on education;

- allowing the private insurance market to play the main role in covering insurable risks such as accidents and sickness;

- stronger reciprocal obligations on able-bodied welfare recipients to try to become self-supporting, and forms of time limits on benefits;

- greater parental responsibility to provide for children in the event of marriage breakdowns; and

- a larger role for the voluntary sector and private charity.

Reforms along these lines have been canvassed in two recent New Zealand Business Roundtable publications, *Towards Personal Independence and Prosperity* by Jim Cox, and *From Welfare State to Civil Society* by David Green.

How far can the state withdraw from welfare provision? No one knows at this stage, but the evidence is clear that it can pull back a long way with all-round gains, and a safe strategy would be to move steadily in that direction. Ideally the state should concentrate on providing a safety net of last resort, with support dependent on income and assets tests and on work or training requirements for the able-bodied. There is also clear evidence that families and the voluntary sector are much better placed than the state to deal with many personal problems, and that philanthropic giving expands with lower taxes.

The international trend is to end welfare as we know it because it does not work for welfare recipients, taxpayers or the wider community. New Zealand has no time to lose in abandoning failed policies.

# MISCELLANEOUS

ACT NEW ZEALAND OTAGO/SOUTHLAND
REGIONAL CONFERENCE

# POLITICS, MARKETS AND VOLUNTARY ACTION: DIFFERENT MECHANISMS, DIFFERENT ROLES

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6 AUGUST 1999

# POLITICS, MARKETS AND VOLUNTARY ACTION: DIFFERENT MECHANISMS, DIFFERENT ROLES

In a column in the *National Business Review* in March this year, Rodney Hide led off with the following remarks:

> We are social animals. We spend most of our lives doing things for other people and having them do things for us. We spend very little of our time doing anything else. The time we spend on our own, utterly self-reliant, is almost non-existent. We depend on others most of our lives.

It is true that we can barely survive, and hardly flourish, without interacting with other people. We want to associate with others to achieve instrumental ends – producing more food, exchanging goods, developing new technology – but also because we feel a deep need for connectedness, for love and friendship and community.

Rodney Hide went on to point out that there are only three ways you can get another person to do something for you.

The first he called love, as expressed by the habits we practise in our families and with those who are close to us. We take care of children and older people and other people who are dependent on us. Voluntary action also includes favours to others without monetary compensation, and these favours may sometimes be reciprocated. We are also motivated by common interests to band together in clubs and community organisations to pursue all manner of voluntary collective endeavours.

The second way of getting people to do things is through trade. Trade is another form of reciprocity in which we exchange one thing for another, usually through a monetary transaction. Thus we exchange money for goods and services that we need, exchange labour for wages, and exchange savings for interest or other investment returns. Trade is a powerful mechanism of cooperation among people who often do not know one another and may live at the opposite ends of the earth.

The third way of getting someone to do something for you is through force. Rodney Hide saw force as contributing nothing good to society. In a private setting this is true, and the use of force against another person to get what you want is unlawful. But for more positive reasons we give the state a monopoly on coercion. We allow governments to use force to protect life and property, pass laws to require compulsory education or allow land to be taken for a road, and to regulate aspects of private and commercial life. The legitimacy of many of these coercive powers may be hotly debated, but few deny that some of them are a necessary feature of a free, peaceful and well-functioning society.

Looking at the world in this way helps, I believe, to dispose of some of the myths that too often cloud political debate. It disposes of the idea that an advanced modern society can be 'individualistic' in any meaningful sense – we are indeed all social animals. It disposes of any notion that "everything can be left to the market" to meet social needs. And it provides a much better way of thinking about the role of government and what we want governments to do.

Above all – and this is the issue on which I want to elaborate – it brings out the point that democratic politics, markets and voluntary action are not ends in themselves but rather means to various ends. They are mechanisms that we can use to pursue what each of us wants in life or wants for others. Democratic governments, for example, have no independent resources or capacity to do good; they can do so only by using resources that belong to all citizens. In a sense then, governments are us, and they are our servants not our masters. Markets are not impersonal entities with powers of their own; they are simply the mechanisms people use to trade. Thus markets are also us. And the alternative to politics is not just markets; markets are only part of civil society, which also includes the host of voluntary, non-market transactions we engage in every day. Civil society embraces both commercial businesses and non-profit organisations; it is everything that is not coercive but natural or voluntary. Thus all of civil society is us too. Politics, markets and voluntary action, in other words, are all means by which individual citizens pursue happiness, as the American founding fathers might have put it.

The extent to which societies use each of these mechanisms for pursuing their self-chosen ends varies in time and circumstances. For Robinson Crusoe on his desert island, markets and government did not come into it. Even when Friday appeared on the scene, one imagines that most transactions were a matter of voluntary reciprocity. With tribes and other small societies, the closeness of bonds meant that many things could still be handled in informal ways, though trade and markets started to enter the picture. In later, more extended societies, governments became necessary to provide a framework of rules within which people could interact productively, and to ensure that certain public or collective goods were provided. In circumstances such as war, markets have been partially suppressed, and much of society mobilised by edict to serve the national interest.

Some people see the family or the tribe as a model for the wider society. However, the things that make a family work – the intimate knowledge of each other's needs and understandings about how resources are shared – do not extend very far. Markets are needed in this situation in order to permit specialisation and allow a rational division of labour. But markets cannot function without rules – in particular, clear understandings about who owns what and how things may be exchanged. In this sense there is no such thing as a free market or 'unbridled laissez faire'. To operate effectively, markets need a set of rules which, at least to some extent, are 'made by government'.

However, just as there is no such thing as a wholly free market, there is no such thing as a wholly political society either. Clearly economic life would rapidly become dysfunctional if we had to rely on voting mechanisms to obtain our daily bread. In the centrally planned economies reliance on government direction for the ordinary decisions of everyday life contributed to their collapse. And at least since Magna Carta, free societies have wanted to place limits on sovereign power and to insist on certain basic rights and freedoms being "retained by the people". At first the battle was to constrain authoritarian rule by kings and queens (especially the power to tax). In modern times, the struggle has been to control the abuse of parliamentary power.

What all this adds up to is the proposition that the essential social problem is to work out what mechanisms are best used for what purposes. We need them all, but each has advantages and disadvantages. Governments cannot do everything, so we need markets. Equally, markets cannot do everything, so we need governments. And neither governments nor markets can replace the many informal, voluntary associations throughout society. None of these mechanisms is perfect and all-embracing. We have to decide on the best mechanism, or combination of them, to use for the purpose at hand.

The institutions of civil society have many strong points. The clear establishment of property rights, for example, provides incentives to invest and take care. Voluntary exchange – either for love or money – allows people to specialise in what they do best and to get some of the things they need through trade with others. Everyone is better off than if they had to be self-sufficient. Markets economise on the use of information – it is embodied in prices that reflect relative scarcities, and does not have to be collected at great cost centrally. Markets also facilitate choice and competition which are important for freedom, entrepreneurship and productivity.

But civil society also has weak points. Men and women are not angels. They need to be restrained by conventions of morality and the rule of law. Abusive and opportunistic behaviour is a reality. The needs of some of the vulnerable may not be catered for without government intervention. In the market domain, there are problems of supplying public goods which cannot easily be charged for, of externalities like pollution where the costs of production fall on others, and of monopoly. These so-called 'market failures' may need to be remedied. Also, markets do not guarantee particular distributional outcomes – some people may not secure what we regard as a decent minimum living standard and may fail to be helped by others.

For their part, political institutions also have strong points. We need governments to protect life, liberty and property, and to facilitate market processes. Without reliable weights and measures and a sound currency, for example, trade is difficult, and standard laws for the incorporation of companies and other business entities reduce the costs of business transactions. Only governments can ensure public goods such as defence, police and the courts are provided on an efficient basis; moreover, we do not want to give powers of coercion to private parties. We want governments to ban some things that could be traded in markets, such as votes or hard narcotics, and to prohibit transactions such as slavery. Most of us would want governments to provide a social safety net to take care of people unable to care for themselves and not helped voluntarily by others. All this constitutes a substantial agenda for governments; the sensible goal is not to do away with government but to establish its proper functions and to ensure that it undertakes them efficiently.

Just as markets have weaknesses, however, so too do political institutions as mechanisms of choice. For a start, we typically have to vote for only one of several political parties, some of whose policies we like and some we dislike. We cannot signal with our votes how intensely we prefer some things relative to others within our preferred party's bundle of policies. Then we have the problem of holding politicians accountable – a problem that is particularly acute with proportional representation systems of government where deal-making and compromise to form coalitions after elections is almost inevitable. In such systems small, unrepresentative parties can hold the balance of power, but even majority parties can force through decisions with which many people disagree. In turn, elected politicians often have trouble holding the agencies of government accountable for implementing their policies. And as the body of research known as public choice has taught us, politicians frequently pursue the narrow interests of groups which support them rather than the general public interest. These political failures are often more difficult to remedy than market failures. The fact that a fish cannot fly should not make us jump to the conclusion that a rhinoceros can do any better.

So we are left with a dilemma. All feasible mechanisms for choices about how we run our lives are imperfect. How do we choose which to use for which purpose, and where to put the emphasis?

As far as the emphasis is concerned, the tendency over the past century has been clear. As Antonio Martino, a former Italian foreign minister, put it in his Sir Ronald Trotter lecture in Wellington last year:

> The century that's coming to its end has been the century of the state, a century of dictators, the century of Hitler and Stalin, as well as the century of arbitrary government, and of the unprecedented intrusion of politics into our daily lives – a fascist century. It has produced the largest increase in the size of government in the history of mankind. Just to mention a single, but very significant, indicator: in 1900 the ratio of government spending to gross domestic product (GDP) in Italy was 10 percent, in the 1950s 30 percent, and it is now roughly 60 percent. Similar trends have occurred in most countries.

In New Zealand, total government expenditure was 53 percent of the economy in 1986 and it is projected to be 41.5 percent this year according to the Organisation for Economic Cooperation and Development (OECD), up from 39 percent in the mid-1990s.

In most countries, however, the government expenditure ratio has stopped growing, reflecting the view that has developed over the past 30 or so years that governments have over-reached themselves and that we need to make greater room for markets and voluntary action. Governments are no longer nationalising industries; indeed over the past couple of decades there has been a major worldwide movement to privatisation. Likewise there has been a large measure of economic deregulation in many countries, including New Zealand, although in social and environmental areas regulation has continued to grow. As yet, we have seen little rolling back of state welfare apart from in the United States, but the social problems and costs associated with the welfare state seem likely to loom large on the political agenda of many OECD countries in the period ahead.

What has brought about this change of emphasis? I think the answer is that judgments about the relative strengths and weaknesses of political institutions and civil society have shifted. Economic and public policy research undertaken in recent decades has been influential. Democracy (universal suffrage) can be expected to work better as the electorate becomes more literate and educated and 'sees through' demagogues and economic snake-oil. Some of the problems with markets have turned out to be exaggerated. The problem of monopoly is greatly reduced when markets are opened to competition; the most serious problems of monopoly in New Zealand today are where it is created by statute, as with the single desk producer boards. Problems of externalities are also much reduced where property rights are clearly specified and prices are allowed to reflect true economic costs. Inefficiency and poor growth caused by high tax rates have encouraged many countries to start to constrain spending.

There is still, however, a level of unease in many countries – certainly in New Zealand, less so in the United States and some Asian countries – about allowing greater roles for the market and civil society. Critics of markets have generally come to accept they are more productive institutions relative to the alternatives. They happily use markets to buy everything from their daily bread to products which inspire wonder and delight. Yet these critics still associate markets with things no reasonable person would like.

Some of these perceptions are, I believe, misplaced. For example, the market is still traduced as the venue for anti-social 'greed'. To be sure, greed exists in all societies, but is it really our daily experience that we encounter rampant greed in our dealings with our corner dairy, general practitioner, employer or landlord? Are efforts by people to increase their incomes fairly described as 'greed'? I have already noted that far from being 'individualistic', participants in markets are utterly dependent on all kinds of social interaction and cooperation. The criticism of individualism can be more fairly levelled at the ethic of entitlement 'rights' that has grown up under the welfare state, whereby actions have been removed from their moral and social context and consequences. This has undermined institutions like the family, churches and charitable organisations.

It is true that markets will not always deliver outcomes that are consistent with our concepts of fairness, or a decent minimum standard of living for all. But we should recognise that civil society has the capacity to cope with some of these problems through voluntary means, and we should not be too quick to come to the conclusion that political institutions always score more highly on fairness grounds. It is, for example, a fact, as the attached chart shows, that freer economies tend to have more equal distributions of income. Despite the alleged commitment to equality in the Soviet Union, in 1939 the upper 11–12 percent of the population accounted for some 50 percent of national income (in the United States the share of the top 10 percent is around 35 percent today). A large part of the income redistributed by the welfare state goes not to lower income groups but to the middle classes. And in the final analysis, while redistribution on compassionate grounds is a valid government role, wealth creation associated with free and open markets is a far more powerful tool for raising the incomes of the poor.

I have spoken mainly of the economic consequences of the choices we make between politics, markets and voluntary action. But that is by no means the whole story: economics

– in the sense of material living standards – is important, but it is not the whole of life. We should also evaluate these choices in terms of other consequences – for example for morality, liberty and peace – and in most cases the relative emphasis points in the same direction. I have mentioned that the moral foundations of a free society can be undermined by state action. As regards economic and personal freedoms, Thomas Jefferson pointed out long ago that "the natural progress of things is for government to gain ground and liberty to yield". Economic freedom is necessary for political freedom. And the prospects for international peace are surely enhanced by trade and commerce, and threatened by state power and a weakening of democratic constraints.

I also believe there are trends at work which will shift the emphasis further away from politics as a mechanism for achieving our goals. There has been a loss of confidence in democratic politics worldwide and in New Zealand, as the recent Massey University study of values, which found that only 16 percent of New Zealanders had confidence in government, confirmed. Globalisation is reducing the pricing power of firms everywhere and breaking down monopoly positions. The solutions to many environment problems are increasingly seen not as requiring greater government regulation but better use of property rights, prices, markets and other incentives to care for and conserve natural resources. Technology is reducing the range of activities that were formerly seen as public goods – private alternatives are mushrooming in areas such as telecommunications, broadcasting and even infrastructural services such as roading. And I suspect that continuing public dissatisfaction with state-provided health and education services is likely to see a far greater role for private alternatives – both for-profit and not-for-profit – in the period ahead.

So my prognosis is that the twenty-first century is not likely to be another century of the state. When we recognise how prone the engine of government is to malfunction, we should not be too demanding about the load we expect it to haul. Since 1993, the ratio of government spending to GDP has fallen in most OECD countries – an historic turnaround. Even though the many beneficiaries of the modern regulatory state will fight tenuously to defend their interests, I suspect the state's role is likely to continue to shrink, with major implications for politics and political alignments in the period ahead.

But that is not the main message I want to leave from this talk. The main message is that we ought to be able to lower some of the political temperature in debates over social problems by recognising the roles that government and civil society both have to play in dealing with them. Those who wish to emphasise the role of markets and voluntary action are not enemies of government. To the contrary, they want to see governments doing the jobs that only governments can do, and doing them well. Maybe these roles will be more modest in the future, as they were only a few decades ago, but that does not detract from their importance.

By the same token, supporters of civil society should not be detractors of politics and politicians as a class. At the end of this century, it seems a general disillusionment with politics has set in around the world, especially among young people. That has its good aspects but also its bad ones. We need to be able to attract good people into politics to perform its limited but vital role. We need effective political parties and we need to restore respect for the institutions of government. If we could achieve a consensus involving rather more balanced perspectives on the roles of all our institutions, and on the need for all of them to be nurtured and sustained, I believe we might enjoy more success in dealing with our national problems.

**ARTICLE BY DAVID HENDERSON FOR THE**
***EVENING POST***

# ECONOMIC REFORM:
# PAST, PRESENT AND FUTURE

**APRIL 1999**

# ECONOMIC REFORM

Over the past 20 years, in a development which few foresaw, the economic policies of a large and growing number of countries have changed course. Governments have taken steps to reduce the role of the state in economic life. They have made both national economies and international transactions freer and less regulated. They have taken the path of economic reform, of *liberalisation*.

This trend is to be seen across the world. The first clear indications appeared in the late 1970s – in the Chile of General Pinochet, in the China of Deng Xiao-Ping (where 1978 marks a historic break with the past), in the United States with deregulation, and in Britain with the advent to power of Margaret Thatcher in 1979.

In Australia, a turning point came at the end of 1983, and in New Zealand, more dramatically, after the election of mid-1984. In both cases, far-reaching reform programmes were adopted by governments of the left. There is nothing surprising about this; there have been many other cases. Economic reform does not represent a victory either for right-wing elements or for conservative ideas. The ideas it embodies are those of economic liberalisation.

In the continuing story, a number of episodes stand out. Liberalisation has gone ahead across Latin America, with Argentina as an outstanding case. In Europe, the Community has established the Single Market. From 1989, after the collapse of communism, the reform process spread to most of the countries of the Soviet Union and Central and Eastern Europe. In 1991, in what may prove to be a landmark event, the government of India brought in reforming measures. In 1994, the Uruguay Round trade negotiations finally resulted in a positive outcome.

The main areas of reform have been financial markets and international capital flows; international trade; and the privatisation and deregulation of formerly state-owned industries and enterprises. Many countries, including New Zealand, have also introduced tax reforms. In other areas, however, such as labour markets (except for New Zealand and the United Kingdom), and the control of public expenditure (with Ireland as a notable exception), the extent of reform has been limited. On the other side of the balance, the impact of economy-wide regulation in areas such as conditions of employment, environmental standards, and taxation has probably intensified.

Among reforming countries, the two that stand out up to now are New Zealand and Argentina, since in both cases substantial changes have been made on a wide front.

Over the whole 20-year period, there has as yet been no case in which the trend towards liberalisation, once adopted, has been reversed. This includes cases such as Britain, France and Germany today, in which governments of the left have taken over. This suggests that the main reforms have come to stay.

Will the trend to more liberal economic systems continue? As always, prediction is a risky business, but recent history provides some pointers to the future.

I believe that there will be a process of consolidation, of closing up, in which the main reforms that have so far been adopted will spread across the world. Countries such as India and Russia, where liberalisation has not as yet been taken far, are likely to converge on the rest.

More generally, the cause of reform is likely to benefit from three factors. One is the continuing spread of democratic forms of government, since political and economic freedom are linked. A second is the further development of communications, including the

Internet. This opens up new possibilities for competition, and makes it harder for governments to restrict the freedom of action of people and businesses. Third, pressures for reform are likely to arise from resistance to the increases in taxation that in many countries would become necessary if present-day health, pensions and social welfare programmes were left unchanged.

However, there are influences also in the other direction. Up to now the main reforms have been in areas where market mechanisms were already well established and accepted. In other areas, however, including health, education and social welfare, the regulation of labour markets, and environmental concerns, there is strong opposition to extending the scope of markets. In the international sphere, 'globalisation' is widely viewed as a threat.

Despite the extent to which liberalisation has been taken over the last 20 years, the ideas of economic liberalisation are not widely accepted in any country. Most of the political leaders who backed reforms were pragmatists, rather than disciples of Adam Smith or Freidrich von Hayek. These leaders made economies freer because this seemed the right way to respond to the issues, pressures and problems that confronted them. This is likely to be the pattern of the future. As in these recent years, the main single influence on the direction of policies will be the impact of events on the climate of opinion.

**HARBOUR CITY ROTARY CLUB**

# THE NEW ZEALAND BUSINESS ROUNDTABLE AND WHAT IT STANDS FOR

**SIR RONALD TROTTER**
**MEMBER**
**NEW ZEALAND BUSINESS ROUNDTABLE**

**WELLINGTON**
**10 MARCH 1999**

# THE NEW ZEALAND BUSINESS ROUNDTABLE AND WHAT IT STANDS FOR

I am delighted to be here today to talk to you about the New Zealand Business Roundtable. It is an organisation I am very proud to be associated with. Its mission of promoting better public policies relates to the welfare of all New Zealanders.

The Business Roundtable is an organisation that believes in an open economy and it operates in a very open manner. It bases its arguments on careful analysis and well-established economic principles. Because some interest groups and politicians have felt threatened by its proposals they have tended to attack the organisation rather than debate the ideas. As a result, many myths and misunderstandings have been created. I hope to dispel some of them today.

The Business Roundtable began in the early 1980s as an informal, loose association of business leaders who had started to rethink the old ways of doing things. Most of you will recall vividly the features of our economy in those days: a mass of government interventions driven largely by the interests of various pressure groups.

Most business people at that time were pushing business or sectoral interests. I was one of them. Let me give you an example from my time with Fletcher Challenge. The company was a major exporter and a large employer. But high domestic costs resulting from the protected economy and a corporate tax rate of 45 percent meant we and many others struggled to make a profit on our exports. It did not really occur to us to question the whole structure of the economy. So what was the solution? The government, with the encouragement of business, provided export incentives. Fletcher Challenge did not have to pay tax for several years; export incentives were worth about $40 million a year to the company.

Like many other business people at the time, I was a defender of export incentives. They seemed to be the only way of keeping export industries viable. But the reality was that while Fletcher Challenge was one of New Zealand's leading businesses and seen as a major contributor to the economy, it was in fact a corporate welfare beneficiary.

Likewise, I was one of the thousands of farmers who benefited from tax incentives and transport subsidies, supplementary minimum prices, livestock incentives and land development loans. I used a land development grant to clear some gorse. With tax deductions and loan write-offs, it cost me nothing and the taxpayer footed the bill for an exercise that was probably totally uneconomic. Thus I was among the few who were lucky enough to get a larger share of the cake, without noticing that the cake was barely growing.

Along with farmers, the most powerful pressure groups in those days were the Manufacturers Federation and the unions. All three sectors lobbied for their particular benefits and so the elaborate network of import controls, exchange controls, wage controls, price controls and subsidies was created. It was one huge interlocking grid of special interests. And, as we all know, in the mid-1980s the whole shaky structure fell over.

The catalyst that really sparked the formation of the Business Roundtable in its current form was the Economic Summit held in 1984, shortly after the election of the new Labour government. This event brought together representatives of all sectors of the economy and society who met in the parliamentary debating chamber to discuss the problems the country was facing and the need for new directions. I was chair of the organising committee. It was a fascinating and rewarding experience.

A lot of information on the state of the economy was distributed beforehand and at the end of two days those present signed up to a joint communiqué that set the stage for reform.

Many senior business people involved in the Summit saw it as being in their own interests for the distortions and costs of subsidies, protection, debt and inflation to be removed. We saw that, long term, our prosperity was inextricably linked to the growth and prosperity of New Zealand.

We came together afterwards to form an organisation that would promote the development of policies for a more prosperous and growing economy. The Business Roundtable was formed with initially about 25 members and in early 1986 we engaged Roger Kerr as our executive director.

Today, the organisation numbers around 50–60 chief executives of major New Zealand firms. Our mission remains unchanged. Let me read an extract from our founding document – our statement of purpose:

> The NZBR is committed to contributing to the overall development of New Zealand and to promoting the interests of 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.

Over the past 13 years, we have stuck firmly to those principles. We have not promoted special interests, and there has been no pressure within the membership to do so. In the early days, a few members who found they did not fully share these views simply resigned. Today, even though some members occasionally find our views run counter to what may be good for their business, they continue to be committed to putting the national interest ahead of any private or sectoral interest.

Our specific goals are simple: we want a better New Zealand; we want to see a growing, dynamic economy; we want smaller government – not for its own sake but to facilitate that outcome; and we seek broad consensus on sound policies.

How do we pursue these goals? Our basic tools are debate, research and published material.

We meet for half a day five times a year. At these meetings members identify and discuss the issues of most concern. Our membership is by invitation but it is a very representative cross-section of major businesses. Usually about half our members are able to attend each meeting, so that means everyone can literally get together around one table to air their views. Our office has a total full-time staff of four and a budget similar to other business organisations. We use outstanding academics and consultants from New Zealand and overseas to work on our projects.

We invite two or three speakers to each of our meetings to brief us or present views on issues of interest to members. We plan an annual work programme and commission research and analysis on a range of topics. Throughout the year we publish a number of books, reports and papers, and produce a steady stream of submissions and statements on issues we regard as important. Where appropriate, we organise seminars and forums and bring out top-quality international academics to stimulate and contribute to New Zealand debates.

An example is the visit in a fortnight's time of Richard Epstein, professor of law at the University of Chicago and an outstanding law and economics scholar. During his week-long visit, we will be taking him to Auckland, Wellington and Christchurch where he will address groups and deliver lectures on topics such as takeover regulation, employment law, telecommunications regulation, MMP and educational theories.

We place a very strong emphasis on high-quality, objective analysis. Roger Kerr is ultimately responsible for maintaining our standards and is highly respected internationally for his work. Quality is particularly important in view of the fact that we do not seek to work through personal lobbying of politicians. Naturally we meet periodically with politicians and we try to maintain good relations with all major political parties, but we prefer to rely on our published material and analysis for influence. That does not mean that we are afraid to persist with arguments that initially encounter opposition. One cannot underestimate the power of ideas. It may take time, but in the end good ideas will count more than the vastly exaggerated power of vested interests. It is interesting to see policy ideas that are at first widely rejected reappearing later as someone else's proposal.

We will continue to question critically the way New Zealand does things and ask whether existing practices and structures are helping to make this country competitive. Our stance on producer boards is an example. There we have taken on some of New Zealand's most sacred cows. We have argued for the elimination of unnecessary regulation and the inefficiencies associated with monopoly structures. If the government moves to introduce competition and create a normal commercial environment in this important sector, it will be good for everyone – growers, farmers and New Zealanders as a whole.

Producer board reform has very little to do with the core business of our members. In fact, probably only one Business Roundtable member company could be seen as a competitor to any of the boards. Our determination to pursue this issue is based on our view that deregulation would be good for New Zealand as a whole. That is why it was very disappointing to see the government back away from its agenda last year in the face of opposition from the boards. It is the same old problem of the electoral power of interest groups, all the more so under the Mixed Member Proportional electoral system (MMP).

Producer board reform is one of a number of issues we have been chipping away at for some years now. At the beginning our position was considered extreme. That has been the pattern with many of the issues we have pursued, such as port reform, the Reserve Bank Act 1989, deregulation of the labour market, and changes to retirement income policies. Today, the results of these reforms are a fact of life – benefits we now take for granted from changes which a few years ago would have been considered unthinkable or outrageous.

Encouraging the state to get out of running business enterprises is another example. We were advocating this at a time when, for many politicians, 'privatisation' was a dirty word and evoked images of the family silver heading overseas. Now the results speak for themselves. Look at the advances in telecommunications and airline services, to name but two. Not even the most committed statists appear to be advocating a return to the bad old days of state ownership.

None of these changes – all radical ideas at the time – has been won easily. But when you challenge sacred cows, you can expect opposition. New ideas will always be suspected and vested interests will not give up their privileges without a fight. Criticism is not something that bothers us if we are satisfied our thinking is sound.

Of course, the Business Roundtable has not been solely responsible for these changes. Many politicians, organisations and individuals have promoted similar ideas in New Zealand over the last 15 years, and their thinking has been in tune with worldwide trends. What is noteworthy, however, is that over the years virtually the whole of the business community has moved to policy positions similar to our own.

The notion of a group of leading business people promoting overall national interests has been difficult for the public to grasp, especially given the behaviour of business groups in the past. There have been plenty of emotive accusations of greed and self-interest, as well as political and ideological labels. However, the Business Roundtable is a strictly apolitical organisation and we are comfortable with any political party which shares our general perspectives. Thus, in the 1980s our thinking was broadly in tune with the economic liberalisation programme of the Labour government, while in the 1990s it has been more in line with that of the National government, at least during the early part of the decade. But the government's lack of positive direction in the last two terms of parliament has become a serious concern. The country has been drifting for too long and lost much of the momentum achieved in the early 1990s.

Our message to the government is quite simple: get the economy back on course. While the current upturn is pleasing, the outlook is not exciting and the country is still not where it should be. Serious underlying problems reflected in the large current account deficit and the growing unemployment rate are crying out to be resolved. The recent trends towards greatly increased government spending and ever-growing regulatory activity are not the solution. We are losing our competitive position and other countries are out-performing us again. New Zealanders do not deserve more pain after toughing it out through years of reform and restructuring.

Many unresolved issues require urgent attention. They include, for example, the problem of our ageing population, roading reform, the need for further privatisation in central and local government, politicised health and education systems, and social welfare expenditure which is costing $32 million a day. The government must get its house in order and look carefully at the quality of its spending and where it intervenes. We cannot create a strong economy and society without government, but that does not mean the government should be involved where the private sector belongs.

So, what messages can I leave with you today?

Think through the implications of government policy proposals: you will be paying for them. Every extra dollar the government spends not only diverts a dollar of income from New Zealand households but also cuts around 30 cents off total national income – because of the costs of raising taxes. Every badly conceived regulation reduces your living standards.

Support the political process and have your say. Help dispel the view held by many New Zealanders that more government equals a more caring society. We must refuse to allow governments to do anything that we can adequately do for ourselves and our communities. Only when the majority of New Zealanders support that view will we have a low tax rate, a high growth rate and low unemployment. But remember, you too must be prepared to give up the benefits that governments over the years have used to seduce you, like national superannuation for those who can afford to save and free health for those who can afford health insurance.

I hope I have helped dispel some of the popular myths about the Business Roundtable and what we stand for. I hope you share our ambitions for a better New Zealand. I hope you agree with our view that there is a large gap between the country's present position and its true potential. If you do, I hope you will think about how that gap could be bridged, consider our ideas for doing so on their merits, and support them if you find them sound.

ACT HAMILTON ELECTORATE

# THE THIRD WAY: NEW PACKAGING, OLD PRODUCT?

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

HAMILTON
9 MARCH 1999

# THE THIRD WAY: NEW PACKAGING, OLD PRODUCT?

The search for a middle way is often a perfectly sensible approach to public policy. An objective of simply 'downsizing' government, for example, would be just as silly as the old socialist objective of public ownership of the means of production, distribution and exchange. The interests of New Zealanders are best served if the division of functions between the public and private sectors is determined according to their relative efficiency. The proper goal is to 'right-size' government. There is nothing novel about this idea – it has been a principle followed in many areas of economic policy reform in New Zealand during the 1980s and 1990s.

Paradoxically, however, the 'third way' has come to be associated with a particular set of views that are not consistent with establishing sensible boundaries between the public and private sectors. Advocates of this 'third way' argue for an increase in the role of the public sector, despite analysis that suggests it should be reduced in the overall community interest. I might have said 'further reduced' but that would hardly be accurate given that, for example, government spending on social welfare has continued to increase – from 11.6 percent of gross domestic product (GDP) in 1983 to 13.5 percent in 1998 – so that it is now more than double its level in the early 1970s (6.2 percent of GDP in 1972).

In New Zealand the idea of a third way was resuscitated last year by the visit of the former US labor secretary, Robert Reich, at the invitation of the Labour Party. During his visit Reich made some good points. One was that globalisation should be accepted, not just because the costs of resisting it are high but because of the beneficial effects of wider markets. Another was that with increased international mobility of capital, a nation's future well-being depends more heavily on the productive capacity of its people – which is partly determined by investment in education and training. In this context he argued for education vouchers at the compulsory education level and for funding tertiary education largely through student contributions – sound ideas which have not yet been taken up by his hosts.

However, the part of Reich's message I want to challenge is his view that in order to maintain social cohesion, the governments of wealthy countries need to adopt a long-term strategy which involves "active market interventions that seek to widen the circle of prosperity and enable more people to be full participants in a global economy". The basic problem, as Reich perceives it, is that "global forces are pulling our societies apart".

Are they really? Would the policy solutions proposed by Reich actually help people who are hurt by globalisation? If available evidence suggests the answer to these questions is 'no', why would anyone think Reich's 'third way' is either necessary or desirable.

**Trends in income inequality**

Robert Reich's view that global forces are pulling our societies apart is based on a revival of the old idea that the rich are getting richer while the poor are getting poorer.

Over the past 200 years, that claim is obviously wrong. In all the industrial countries, living standards have increased more than at any other time in history. The average citizen today lives better than all but a privileged few less than 10 generations back. Just in the past 50 years, the populations of Japan and some other countries in Asia have risen from poverty to levels of income that exceed New Zealand's. A rising tide lifts all boats, if not at the same time and speed. General economic growth is far more important than changes in the share of national income between different groups in improving material living standards.

Moreover, in the successful parts of the world the trend has been towards greater equality in incomes. Many former third world countries have greatly narrowed the gap with the living standards of the West. Within advanced countries the gap between rich and poor has narrowed over the past century. Today's beneficiary has a better standard of living than the average worker 50 years ago. The rich have grown richer but the poor have grown richer faster.

To be sure, those trends have not been at work in all countries at all times. Poverty alleviation and reduced income gaps have been most clearly associated with relatively open, competitive economies – Taiwan, for example, has enjoyed rapidly rising incomes and one of the most even distributions of income in the world. Centrally planned and socialist economies have suffered from stagnant and often very unevenly distributed incomes: Trotsky reported that in 1939 the top 11–12 percent in the Soviet Union accounted for around 50 percent of total income – a far higher proportion than anywhere in the West. I think a focus on improving the position of the poor is much more important than a concern about income gaps – there is no obviously 'right' distribution of income – but it so happens that freer economies are associated over the long run with more evenly distributed incomes.

In New Zealand, the evidence suggests that some of these long-run trends have been interrupted over the past 15 years. Statistics New Zealand has recently traced what has happened to the distribution of New Zealanders' real disposable incomes (adjusted for household composition) over the period from 1982 to 1996. It finds that there has been an increase in inequality, with most of the increase occurring between 1986 and March 1991 (ie during the Labour government's term of office and before the 1991 benefit cuts). This increase is primarily due to those at the top of the income distribution becoming relatively better off, those in the middle becoming slightly worse off, and the income share of those at the bottom remaining unchanged. Thus, contrary to popular opinion, the poor did not become poorer during this period; policies aimed at safeguarding their position were successful.

A key factor affecting pre-tax market incomes in the 1980s was the action of the Labour government in embarking on a major programme of industry restructuring while failing to address the problems of New Zealand's rigid labour markets. As a result, many thousands of workers were condemned to unemployment, which is always a major factor in inequality and hardship. The Statistics New Zealand research shows that in the early 1990s the deteriorating trends were arrested with the freeing up of the labour market and the rapid fall in unemployment which was helped by a more consistent policy framework and general economic growth.

It should also be remembered that the population in the bottom income deciles (or any others for that matter) is not static. The Statistics New Zealand research refers to broad income shares. A large number of those who were in the bottom 10 percent 10 years ago will have improved their position (and some in the top bracket will have moved down). For most people the prospect of moving up the income ladder is more important than the rung they occupy on it at any point of time.

With the weakening of the policy framework since 1993, especially the loss of fiscal discipline, and the damage done by the Employment Court to labour market flexibility, unemployment has been on the rise since 1996. The most distressing statistic and testament to poor policy is a Maori unemployment rate which has gone back up to nearly 20 percent again. High unemployment also puts downward pressure on the wage rates of the working poor. Although the recent tax cuts and increases in family assistance will have benefited many on low wages, it would not be surprising if some trends in income are going in the wrong direction again.

As in New Zealand, trends in income data in other countries need to be interpreted with care. In the United States, the idea that the poor got poorer as the rich got richer during the

1980s and early 1990s is based on income data which is averaged over several different types of family structure. The picture looks different if the data is disaggregated to enable the incidence of poverty among groups with particular types of family structure to be observed. Bill Cline, an economic researcher who has undertaken a major study of income distribution and trade in the United States for the Institute for International Economics, has commented as follows:

> The striking feature of the more disaggregated data is that they show the incidence of poverty has been about constant or declining in almost every major category in recent years, except for white families with female head of household and no husband present. This means that the increase in overall poverty has come to an important degree from a shifting composition of the population toward those categories with higher poverty incidence, rather than from a generalised deterioration within each category.[1]

In recent years it appears that the US economic boom of the 1990s has lifted incomes in practically all categories, but some of the problems of the so-called underclass remain deep-rooted.

**Why advocate minimum wages?**

Many people associated with welfare organisations and churches – people who are genuinely interested in reducing poverty – have tended to support labour market interventions including regulations governing hiring and firing, minimum wages and other regulatory interventions that make it harder for people to obtain work. It is puzzling how anyone could advocate minimum wage regulations, as Robert Reich does, as part of a package of policies which is meant to be an alternative to what he describes as "the mythic contest between the free market and government intervention". The regulation of minimum wages has all the characteristics of the old interventionist approach of attempting to achieve desired outcomes by imposing crude and counter-productive government controls.

The limitations of statutory minimum wages as an anti-poverty device are apparent when it is realised that:

- people who earn low wages do not necessarily come from poor families; and
- wage rates set at levels higher than the productivity of young and low-skilled workers in particular simply exclude them from the labour market.

A recent Organisation for Economic Cooperation Development (OECD) study shows that there is not much overlap in OECD countries between people who are low paid and those who are in low income households. The results indicate that a high proportion of low paid workers are in households that earn moderate to high incomes in all 13 countries included in the study. The lowest proportion is in the United States, where 62 percent of low-paid workers come from households which earn moderate to high incomes. Even Robert Reich acknowledged in 1997 that "most minimum wage earners are not poor".

The study also shows that there is a low incidence of low paid workers among families that are in poverty. The highest incidence of low paid workers among persons aged 16 and over in families in poverty was 13 percent. That figure relates to the United States – the percentage in most other countries was substantially lower. The OECD comments on the reasons for this result as follows:

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1 W Cline, *Trade and Income Distribution*, Institute for International Economics, Washington DC, 1997, p 8.

> The biggest reason ... is the large number of individuals who do not work at all. The low incidence rates make it apparent why minimum wages cannot be considered – and are not designed to be – a tool to reduce poverty across all families: unless workers are present in a household, higher wages cannot affect that household's income.[2]

What this amounts to is an acknowledgment by the OECD that minimum wage policies are poor tools for reducing poverty. They are a cruel hoax on the most marginal workers, preventing them from getting a foot on the bottom rung of the income ladder. No pay is worse than low pay. Testifying recently before the US Congress, Federal Reserve chair Alan Greenspan called for the US minimum wage law to be abolished. Those genuinely concerned about the appalling rate of unemployment among young Maori in New Zealand should be doing the same here.

**What determines trends in wages?**

The fear that market forces are moving us toward a divided and less equal society is nothing new. Karl Marx was, of course, its foremost exponent. But even JK Galbraith, an author who has long been a strong supporter of increased government intervention in economic affairs, recognised in *The Affluent Society* that:

> The first reason why inequality has faded as an issue is, without much question, that it has not been showing the expected tendency to get worse. And thus the Marxian prediction, which earlier this century seemed so amply confirmed by observation, no longer inspires the same depth of fear. It no longer seems likely that the ownership of the tangible assets of the republic and the disposal of its income will pass into a negligible number of hands ... .[3]

Galbraith argued that "it has become evident to conservatives and liberals alike that increasing aggregate output is an alternative to redistribution or even to the reduction of inequality".[4] Robert Reich on the other hand maintains that while this "was probably the right advice at the time", a trend toward greater inequality has since emerged.[5]

Has there been a fundamental change in the functioning of economic systems during the past 40 years? Does recent experience suggest that Marx may have been correct after all in his argument that the labour-saving bias of technological progress would tend to result in a reduction in real wages and increased misery among workers?

The evidence suggests otherwise. Across the world, real wages are highest in the countries which use the most advanced technology and have the highest output per worker.[6] Over the decade to 1995 the relationship between real wage growth and productivity growth has remained strong even in countries with high initial productivity levels – the countries with relatively high productivity growth rates have tended to have relatively high real wage growth. The average rate of growth in real wages (measured by business sector labour costs) for the five OECD countries with the highest growth in labour productivity (measured as GDP per person employed) was 1.8 percent per annum whereas that for the five countries with the lowest growth in labour productivity was zero.[7]

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2 OECD, *Employment Outlook*, June, 1998, p 52.
3 J K Galbraith, *The Affluent Society*, Pelican Books, 1962, p 78.
4 Galbraith, *op cit*, p 88.
5 Robert Reich, 'America's Anguish', *Australian Financial Review*, 6 November, 1998.
6 See, for example, *The Economist*, 20 September, 1997, p 42.
7 There are 20 OECD countries included in the data set on which this calculation is based. Average annual real wage growth for each quartile ranked by productivity growth was as follows: 0 percent; 0.9 percent; 1.1 percent and 1.8 percent.

The OECD is projecting that rates of growth in the labour force of OECD countries will be substantially lower over the next 20 years, even if there is a trend towards later retirement. There has been a great deal of discussion of the implications of changing age distributions for dependency ratios. Perhaps more thought should be given to the possibility that lower labour force growth rates may result in more rapid growth in real wages in the future.

**Is globalisation reducing wages of unskilled workers?**

There are sound economic reasons why globalisation – freer trade in goods and services and greater international mobility of capital – may have made some contribution to the widening margin between the pay of skilled and unskilled workers that has been observed in many industrialised countries since the early 1980s. It is an implication of the Stolper-Samuelson theorem – a basic foundation of international trade theory – that trade between wealthy countries, which are relatively well endowed with skilled labour, and poor countries, which are relatively well endowed with unskilled labour, will tend to reduce the price of unskilled labour and increase the price of skilled labour in wealthy countries. As *The Economist* puts it:

> The effect of imports from poor countries is therefore akin to expanding the supply of unskilled labour in the West, which causes its price there to fall. If this is so, then trade with the developing world may make the advanced economies as a whole better off, but at the expense of lower pay for the unskilled.[8]

On the other hand, of course, unskilled labour in poor countries tends to benefit from these trends.

There has been a great deal of academic research on the effects of globalisation. A good survey of the relevant literature has been undertaken by Bill Cline, who argues that there are grounds to reject extreme estimates (both high and low) of how much of the observed increase in disparity between skilled and unskilled wages in the United States is attributable to globalisation. Cline concludes that "on a balanced reading of the existing literature, about one-fourth to one-fifth of the nearly 20 percent rise in the skilled/unskilled wage ratio over the past two decades has been from the influence of trade and immigration".[9]

Cline also makes the important observation that the increase in the skilled/unskilled wage ratio was the net effect of several factors. For example, in the absence of any other change, the increase in availability of skilled relative to unskilled labour in the United States over this period could have resulted in a fall in the ratio of skilled to unskilled wages of the order of about 40 percent. When account is taken of a whole range of factors, including labour-saving technological change, which are likely to have increased the skilled/unskilled wage ratio, Cline concludes that trade and immigration may have accounted for "only about one-tenth of the gross unequalizing forces".[10]

Cline makes several other points which help to put the effects of globalisation into perspective:

- Despite globalisation, a large sector of all economies is devoted to production of goods and services that are not traded internationally. This tends to limit the effects of free trade on the skilled/unskilled wage ratio.

- Even if all goods and services were traded internationally, the wages of both skilled and unskilled workers would remain much higher in industrial countries than in

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8 *The Economist*, 20 September, 1997.
9 Cline, *op cit*, p 257.
10 *ibid*, p 268.

developing countries because of the higher technological efficiency of the former (and the relative absence of problems such as corruption and weak legal systems). Despite lower wages, the average labour cost per unit of output of manufactured goods is often higher in developing countries than in industrial countries.

- The impact of increased trade on the absolute wage levels of unskilled workers in the United States was substantially offset by its effect in reducing the prices of goods purchased by these workers.

- Future moves toward free trade are unlikely to cause much change in wage inequality and are unlikely to cause absolute reductions in unskilled wages.

**Would increased education subsidies reduce inequality?**

It is arguable that by increasing the supply of skilled labour relative to unskilled labour, further public subsidies for education and training could arrest increases in the ratio of skilled to unskilled wages. There is some evidence which suggests that the increase in this ratio in the United States is partly attributable to the fact that "the supply of educated workers increased at a decreasing rate during the 1980s".[11] There is also some evidence that countries in which the supply of skilled labour has increased most rapidly experienced smaller increases in the ratio of skilled to unskilled wages.[12]

However, reducing the ratio of skilled wages to unskilled wages does not make much sense as a public policy goal. In terms of equity, it is not obvious what is gained by imposing high taxes in order to subsidise the tertiary education of people who come from high or middle income families. Moreover, given the increasing ability of skilled people to sell their services into a global market, it is even doubtful whether the training of increased numbers would have much effect in the longer term on the ratio of skilled to unskilled wages in some occupations.

Government subsidies to education also have important implications for the efficiency of resource use. It is likely that government subsidies tend to encourage some students to undertake studies which they would not otherwise have done, even if they had access to long-term loans to cover fees. Given research findings that the benefits of higher education are very largely captured by the students themselves, in terms of their higher lifetime earnings, there must be a strong presumption that subsidies to higher education lead to a misallocation of human resources.

Public investment in education is a major plank of Reich's third way. He asserts:

> What keeps and attracts private sector investment to any given place on the globe is the quality of public investment in education, job training and human capital in general.[13]

A moment's reflection indicates that this claim is nonsense. Russia has maintained quite high standards of scientific and technical education, but this advantage is of little avail in attracting investment in a general climate of lawlessness and weak institutions. There is plenty of evidence of the importance of human capital in the economic growth process, but none I am aware of that suggests higher public subsidies for education raise average wages – often they create gluts in the graduate labour market and lead to emigration of many graduates of the most heavily subsidised courses.

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11 P Gottschalk and T Smeeding, 'Cross-National Income Inequality', *Journal of Economic Literature*, Vol XXXV (June 1997), p 650.

12 Gottschalk and Smeeding, *op cit*, p 655.

13 As reported in *The Listener*, 4 July, 1998.

The critical issue is how the efficiency and equity of existing arrangements for the provision of education services can be improved. The New Zealand Business Roundtable's view is that the efficiency goal could best be met through a subsidy based on the public good element of courses. On average, this element is unlikely to exceed 30 percent of university tuition fees. The equity goal would be best met by targeting disadvantaged students rather than by universal subsidies.

When the introduction of a greater element of user pays in education is suggested, there is a tendency for some people on middle and higher incomes to raise the argument that they are already paying for the cost of their children's education through high tax rates. In fact, what they are paying for through high tax rates includes the provision of many different forms of state welfare for their own groups and substantial waste associated with inefficient use of resources, including the deadweight costs of taxation. A general move away from public provision and middle-class welfare would result in a lower structure of taxes, providing more scope for self-reliance by people who do not really need government assistance.

**Defining the real problem**

Robert Reich presents his third way as an alternative to what he sees as the rigid but cohesive societies of Europe with high levels of unemployment and the booming economy of the United States with exceptional rates of job creation but rising inequality. The third way is intended to generate jobs and promote equity.

This sounds like an attractive idea, but we have already seen that the part about rising inequality in the United States – to the limited extent that it has a factual basis – has more to do with family breakdown than with the effects of openness and economic growth. Likewise, the part about the cohesive societies of Europe also has a high fictional content. Does Reich really believe that a stagnant economy with high long-term unemployment – and a substantial proportion of the population dependent on welfare – is a recipe for social cohesion?

There are good reasons to think that there is a stronger basis for social harmony in a prosperous economy, where people form networks to engage in mutually beneficial economic activities and voluntary work, than in a stagnant economy where the redistribution activities of government are central to social cohesion.[14] The following points are relevant in this regard:

- Economic prosperity is generally associated with widespread opportunities. International comparisons show a high correlation between the rates of growth in average incomes of the bottom 60 percent of the income distribution and overall rates of economic growth.

- Rules of society which promote economic prosperity also tend to provide a strong basis for social harmony. These rules include respect for the property of others, observance of contractual obligations, and equal rights before the law regardless of factors such as wealth, race and religion.

- The assumption by governments of major responsibility for income security involves what has been described as a 'quicksand effect'.[15] Rather than providing firm foundations for supporting people against poverty and uncertainty, the prevailing systems in many OECD countries have tended to give way when weight has been put on them. Increasing numbers of people have become entitled to public support,

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14 These issues are further discussed in: W Bates, *The Links Between Economic Growth and Social Cohesion*, New Zealand Business Roundtable, Wellington, August, 1996.

15 D Snower, 'Challenges to Social Cohesion and Approaches to Policy Reform', in OECD, *Societal Cohesion and the Globalising Economy*, Paris, 1997.

> but as its cost has increased the political and economic pressures on governments to reduce support have also grown.

A lesson we should draw from the past century is the need for political parties to consider very carefully what their objectives are when they seek to redistribute incomes. A century ago there may have been some grounds for concern that wealth was unduly concentrated in the hands of a few people, who were able to exercise disproportionate political influence to protect themselves from competition. There is now much less reason for such concern. For example, it would be impossible to argue that Bill Gates, the wealthiest person in America, has been able to use his wealth to protect his firm from competition. And as Peter Drucker has pointed out, at the height of his fortune, JP Morgan could finance all of America's economic needs (except residential housing) for four months. Bill Gates's US$100 billion would do the same job for perhaps a week. As Drucker says:

> The rich no longer matter. ... The real capitalists are the middle-class people who put $25,000 into a mutual fund – that's many trillions of dollars.[16]

Closer to home, it is simply wrong to assert, as some people do, that the wealthy have been the main beneficiaries of the economic reforms undertaken in New Zealand since the mid-1980s. The *National Business Review* has pointed out that "at $6.285 billion, the wealth on the latest list is less in inflation-adjusted terms than the $5.296 billion reported on the first Rich List in 1986". The wealth of many rich people declined during the 1980s as economic privileges such as protection, subsidies and tax concessions were removed.

It would be a good idea if New Zealand's political parties were to abandon the politics of envy and resentment which leads to the peculiar idea that achieving a more equal distribution of income is somehow a more desirable objective than reducing poverty. It is interesting in this context to revisit the work of Arthur Okun, published during the 1970s, which popularised the notion of a trade-off between equality and efficiency. Okun makes plain that the objective he had in mind was to reduce poverty:

> I have stressed particularly the urgency of assisting the bottom fifth on the income scale and helping them into the mainstream of our affluent society. I believe that programs to help them rise would generate momentum through time and into wider ranges of the income scale. If those at the bottom receive the contents of the leaky bucket and are granted greater equality of opportunity, most will get on their own two feet.[17]

The leak in the bucket that Okun refers to is the waste of national product that occurs as a result of the effects of redistribution on the economic incentives of the rich and poor, and the administrative cost of tax collection and transfer programmes. The idea of a trade-off between efficiency and equality poses the question of how much additional waste is acceptable to achieve a further reduction in poverty. In the current New Zealand setting, this question hardly arises in a stark form. There is ample scope to achieve both greater efficiency and greater equality by restructuring existing programmes – to eliminate middle-class welfare and to provide effective assistance to the poor to improve their income-earning potential. It is paradoxical that much government intervention in areas as diverse as education, health, conservation and the labour market actually tends to result in increased income inequality.

**Concluding remarks**

The main attraction of Robert Reich's third way seems to be in the packaging rather than the product. His third way is differentiated from the utopianism and insularity that has characterised past collectivist approaches in many countries, including New Zealand. He

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16 Peter Drucker, 'The Rich no Longer Matter', *National Business Review*, 27 March, 1998.
17 A Okun, *Equality and Efficiency: The Big Tradeoff*, Brookings Institution, Washington, DC, p 118.

accepts the reality of globalisation and open markets. But it still has a warm and fuzzy feel about it that appeals to people who think that market forces are all about greed rather than mutually beneficial exchange.

The main problem is that the packaging is deceptive. Reich tells a good story, but it does not fit the facts very well. Many of his statistics and findings have been debunked by the US Employment Policy Foundation. When you open Reich's package and look inside what you find are tired old policies like minimum wages, education and training subsidies and progressive income taxes. It is difficult to escape the conclusion that Reich's third way does not amount to much more than a way of making these policies seem relevant and consistent with wealth creation in an open economy.

Steve Maharey, who has been an advocate of a third way in New Zealand, is reported to have said: "The third way is an incomplete political theory. It's feeling its way for another answer to social and economic dogma. It is literally still being invented".[18] But in fact attempts to invent a third way between socialism and capitalism go back a long way. Former British prime minister Harold Macmillan wrote a book called *The Middle Way* in 1938. The failed Swedish experiment with a third way began around the same time. In the light of the repeated experience of such failures, the third way has been described as the fastest way to the third world.

In Britain today, the Blair government's talk of a third way is widely seen as a device for disguising the fact that it is largely following a path which Margaret Thatcher's governments marked out. Attempts to get to grips with the concept as expounded, for example, in the writings of Anthony Giddens, director of the London School of Economics, have been described by *The Economist* as "like wrestling with an inflatable man. If you get a grip on one limb, all the hot air rushes to another".[19] In short, the third way is several planks short of a framework. We would make more progress if politicians just spared us the hot air and discussed their policies without the ideological baggage and within the standard framework of modern economic and public policy analysis.

18 *Waikato Times*, 17 June, 1998.
19 'The Third Way: Goldilocks politics', *The Economist*, 19 December, 1998.

MOUNT VICTORIA ROTARY CLUB

# 'LEFT' AND 'RIGHT':
# STARS TO STEER BY OR BLACK HOLES?

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NEW ZEALAND BUSINESS ROUNDTABLE

WELLINGTON
3 MARCH 1999

# 'LEFT' AND 'RIGHT': STARS TO STEER BY OR BLACK HOLES?

Question: What do the following have in common: Zionist settlers on the West Bank of the Jordan; Winston Peters; hard-line communist opponents of former Soviet leader Mikhail Gorbachev; and the New Zealand Business Roundtable? Answer: They have all been described in the media as 'right wing'.

The 'right wing', it seems, is a remarkably inclusive group. It includes religious fundamentalists and atheists, nationalists and internationalists, central planners and free marketeers. It is a club with very low barriers to entry. Who would not want to join? Indeed, are we not all members of it already? The topic of a debate a few years ago was: "Is the 'new right' all that's left?".

Joking aside, what the list really shows, of course, is that the term 'right wing' is simply media code for 'the bad guys'. The days are long gone when mainstream journalists aspired merely to report facts accurately; nowadays many of them want to tell us what we should think as well. Since international surveys suggest that most journalists identify with the left, it is natural that many use 'right wing' as a term of disapproval. In New Zealand, how often do you hear them talking about the 'left-wing' Post Primary Teachers' Association (PPTA) or Council of Trade Unions, for example? But the fact that the term can be thrown around with so little regard to consistency of meaning suggests that the terms 'left' and 'right' are grossly abused (and overused) in political commentary.

Should we worry about such labels? On Mondays, Wednesdays and Fridays I am inclined not to care: as Shakespeare's Juliet said, "What's in a name?". For the rest of the week I resist capitulating to the idea of putting up with meaningless and misleading classifications.

One reason for resisting is that I find most of the politics of the clearly identifiable right to be distasteful. One group for which the label makes some sense is the right-wing populist movements that have come out of the woodwork again around the world in recent years. A list in *The Economist* included Jean-Marie Le Pen's National Front in France, Pauline Hanson's One Nation in Australia, the Northern League in Italy and Winston Peters's New Zealand First. The foreign editor of the *Australian*, Greg Sheridan, made the same point last year when he wrote:

> New Zealand First is New Zealand's very own right-wing, anti-globalisation party, just like our own One Nation party.[1]

Such parties are extreme economic nationalists opposed to immigration, foreign investment, imports and the global economy. Winston Peters has made it clear he has little in common with the Business Roundtable, and he is right.

Secondly, in a less extreme way, many people identify the politics of 'the right' with conservatism, better-off people, profits, privilege and business. I am definitely pro-business, but most of my working career has been devoted to attacking all forms of privilege, including privileges for business. Being pro-business is not being anti-worker, as socialist mythology would have it. Business is the wealth-creating institution of society; if one is concerned about raising incomes one had better be concerned about business. And as an economist I regard my discipline as all about reducing poverty and raising living standards, especially those of less well-off people. So I had no problem with being quoted in a *Metro* interview as saying "my thinking is probably more 'left' than 'right', if there's still any meaning in those terms".

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1 Quoted in the *NZ Herald*, 18 August, 1998.

But the third and most important reason why I resist the political labelling is that economic and social debate will only advance if people know what is being talked about. As the British economic commentator Samuel Brittan put it in a book entitled *Left or Right: The Bogus Dilemma*, written as far back as 1968:

> The left-right spectrum today obscures more than it illuminates. Political discussion, and perhaps even the conduct of politics, would accordingly benefit if it were to be used much less frequently. For not only is the spectrum concept misleading as a classification of political differences, but its persistence in current discussion has a positively harmful effect. It leads ... to the muffling of important issues, to a bias in favour of certain viewpoints against others, and to the erection of unnecessary barriers between those who should be natural allies.[2]

Confusions about 'left' and 'right' labels go right back into history. Indeed in some ways the wheel has come full circle in the past 200 years. As one writer described the origins:

> The original political meanings of 'left' and 'right' have changed since their origin in the French estates general in 1789. There the people sitting on the left could be viewed as more or less anti-statists with those on the right being state-interventionists of one kind and another. In this interpretation of the pristine sense, libertarianism was clearly on the extreme left wing. This sense lasted up to as late as 1848, with Frederic Bastiat sitting on the left in the National Assembly.[3]

Bastiat was a classical economist in the tradition of Adam Smith: a defender of free-market ideas and a fierce opponent of privilege.

Coming into the twentieth century, many have remarked on the fact that the parties conventionally regarded as being on the extreme left and the extreme right have had much more in common than they have had points of difference. Supporters of communism and various versions of socialism on the one hand, and Nazism and Fascism on the other, all believed in controls, economic planning, dictatorial government and the supremacy of the state over the individual. Mussolini was by origin a fanatical Marxist and Nazism meant National Socialism.

The parallels between the parties of the extreme left and the extreme right extended to the democracies, including New Zealand. Reporting on the change of government in 1984, The Economist wrote:

> Sir Robert Muldoon was usually branded a 'right winger'. ... In economic terms, though, he was as much an interventionist as any Marxist dreamer or socialist soldier. Markets were there to be suppressed or ignored, businessmen to be bullied.[4]

Today it is the Alliance party that has retained the Muldoonist mantle.

People have interpreted the moves away from interventionist policies in New Zealand as a move to the political right, even though they were initiated by a Labour government. They have associated them with similar moves by Margaret Thatcher in Britain and Ronald Reagan in the United States. But as the former senior Organisation for Economic Cooperation and Development (OECD) official David Henderson has pointed out in writing for the Business Roundtable, all OECD governments without exception have

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2 Samuel Brittan, *Left or Right: The Bogus Dilemma*, Secker and Warburg, London, 1968.

3 Jan Clifford Lester, *The Political Compass: Why Libertarianism is not Right-Wing*, Political Notes No 116, Libertarian Alliance, London, 1995.

4 'Muldoonery', *The Economist*, 27 July, 1984, p 17.

moved in similar directions in the past 20 years. In many cases besides Australia and New Zealand, such paths were taken by 'left-of-centre' governments. As Henderson says:

> ... there is nothing incongruous in this latter development, since – contrary to a widely held view – liberalisation does not represent a victory for conservative or right-wing ideas and principles. In this recent phase, as in earlier periods of history when market-oriented reforms were introduced, the true hero of the story is not conservatism but economic liberalism.[5]

This interpretation is surely correct and keeps being confirmed by events. US president Bill Clinton and British prime minister Tony Blair are seen as maintaining the Reagan and Thatcher legacies and extending the reforms associated with them into areas such as welfare. The widely remarked swing to centre-left governments in Europe does not signal any basic change in direction, even in France under a socialist government. As an article in the *Australian Financial Review* put it recently:

> While Chirac presides over a fragmented French right wing, the socialist Jospin, with his able finance minister Dominique Strauss-Kahn at his side, has implemented economic reforms that conservative governments could only dream of – such as privatising state enterprises and introducing a measure of fiscal prudence into France's notoriously bloated budget.[6]

One would have thought that these trends and what they signify would have become clear by now even to the inhabitants of the more remote cells of New Zealand universities. To be fair, the trade union-oriented Centre for Labour Studies at the University of Waikato is – mercifully – hardly representative of academic opinion in New Zealand today, but in a book *First Knights: An Investigation of the New Zealand Business Roundtable* published last year, two of its members displayed all the old confusions.

The authors, Paul Harris and Linda Twiname, did decide that we were genuinely concerned with overall national interests not narrow business interests, and that we were not part of some conspiracy, and for that I suppose we should be grateful. But they set out to refute a claim I made in 1991 that the term 'new right' was an "empty label" and insisted, on the contrary, that "it is perfectly legitimate to refer to the Roundtable as a New Right organisation". They defined right-wing politics as "support for private property, for 'private enterprise', for the defence of the existing class structure, and for existing institutions such as the Crown". They define left-wing politics as "more supportive of public ownership, the promotion of social equality, and the reform or replacement of traditional institutions". They follow other writers who define the 'new right' as combining "market liberalism and individualism" and "conservative moral and social policies", and claim that the Business Roundtable "fits within that definition".

The mildewed Marxist ideology is pretty apparent in the language, but let us try to take the arguments seriously. Problems with them abound. The Business Roundtable is certainly supportive of "private property", "private enterprise", "market liberalism" and "individualism" (assuming this means a sense of personal responsibility), but that often leads it to advocate "the reform or replacement of traditional institutions", which our authors say is characteristic of the left. We are not supportive of "the existing class structure", if by this the authors mean (as I think they do) the privileges of bosses and big business. On the contrary, market liberalism is a threat to such privileges: it exposes business everywhere to competition from new entrants and spreads widely the benefits of markets and property ownership. Equally, it is a threat to what is the true source of privilege today, namely, big government. As for "conservative moral and social policies", I

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5 David Henderson, *Economic Reform: New Zealand in an International Perspective*, New Zealand Business Roundtable, Wellington, 1996 pp 7–8.

6 Sheryle Bagwell, 'The Euro may be Jospin's ticket to Waterloo', *Australian Financial Review*, 19 November, 1998, p 15.

am hard put to imagine what they might be. We have not expressed views on most of the big moral issues, apart from those affecting business. We have advocated educational policies that involve much less government involvement in the provision, financing, and regulation of education, including the choice of curriculum, and changes to social welfare that envisage a far greater role for the voluntary sector and a corresponding reduction in the role of governments. But since such policies would involve a significant rethinking of the social agenda of government, they are surely radical rather than conservative and clearly involve "reform or replacement of traditional institutions".

Many other commentators who remain hostile to economic liberalism persist in trying to understand the policy shifts that have taken place in New Zealand in ideological terms. The reality is that they were motivated far more by the practical realisation that past policies had failed, and had had their worst effects on the very groups that the post-1984 Labour government was most concerned about. Excessive government intervention had created a burden of tax and regulation whose heaviest impact was on lower-income groups. State ownership had created pockets of privilege that made it harder for poorer groups to climb the ladder of opportunity. Misguided welfare policies have not solved the problem of poverty but perpetuated it. Conversely, if free-market policies expanded opportunities and increased economic and employment growth, the poor would be among the first to benefit. And only sustained growth would fulfil citizens' expectations of full-time employment when they need it, and at the end of their lives a comfortable and healthy retirement. All these findings are part of the standard economic literature, which is far more relevant in understanding recent policy directions than any political writing.

If people took the trouble to study some of the original thinking behind the post-1984 changes, they would save themselves a lot of confusion. Take, for example, this quotation from the 1984 briefing to the incoming government from the Treasury, another organisation demonised for its alleged 'new right' views:

> There are many ways to categorise government intervention in the private sector. One common approach is to regard it as a form of interference in the free operation of an otherwise unfettered market. Viewed in this way, an intervention can be classified according to its location in a range varying from "persuasion" or "advice" at one end of the spectrum to virtual complete control (as in sectors of the command economies) at the other. This approach focuses attention on the question: "should the government intervene?"
>
> An alternative and more useful approach flows from the perspective that transactions between individuals and organisations are based on sets of rights and an institutional framework (including, for example, contractual law) which do not have inherent existence of their own but emerge and change in response to pressures of social consensus and political choice. The most obvious body to fulfil the role of "setting the rules of the game" and ensuring that they be followed is the government. In a sense then, all markets can be viewed as having a label attached reading "made by government". Viewed in this way, it does not make sense to treat "free" markets as being at one end of a continuum which ranges from no government involvement to complete government control. Since a decision not to interfere with the operation of an existing market is then equivalent to allowing a given set of interventions to stand, it is more useful to consider the question "what set of interventions is most appropriate?" than to attempt to answer those of the form "should the government intervene?". In any particular intervention decision, therefore, the extent to which market forces are utilised is a matter related primarily to the process by which an objective may be achieved rather than an objective in itself. [7]

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7 The Treasury, *Economic Management*, The Treasury, Wellington, 1984.

To the best of my knowledge, no newspaper has ever seen fit to publish this piece in part or in full. Yet it demonstrates that the official position of the Treasury Department at that time, far from being ideological and dogmatic, was entirely pragmatic. Every suggestion for government action or inaction was to be judged on its merits against alternative courses of action. There were no absolutes on any issue, only matters of degree. But obviously it is easier for the intellectually lazy to label an opposing view as ideological than it is to debate an issue on its merits.

The twentieth century has been the age of what the English jurist Albert Dicey called 'collectivism'. He defined collectivism as:

> ... government for the good of the people by experts or officials who think they know what is good for the people better than any non-official person or than the mass of the people themselves.[8]

Certainly one recognisable dividing line in politics today is between people who want governments to have a large say in running other people's lives and those who think most people, most of the time, can run their own lives better than politicians. On what many regard as one end of the political spectrum we have politicians like Alliance MP Laila Harre who has praised Stalin for achieving "in 20 years what the West had taken 200 years to achieve". The ACT party, which is seen as the party of economic freedom and responsibility, is often regarded as being at the other end of the spectrum. Yet in the German Mixed Member Proportional (MMP) electoral system, ACT's counterpart, the Free Democratic Party, is normally portrayed as a centrist party, in between the Social Democrats on the left and the Christian Democrats on the right. Make sense of that if you can in terms of the conventional political labelling; what it highlights is that the idea of a spectrum has passed its use-by date as a reliable means of analysing modern politics. As we can see from Germany, there is nothing incongruous in an alliance between a free-market party and a modern social democratic one.

Prime minister Tony Blair has talked about repeating the golden Victorian era when Whig and Tory shared fundamental beliefs about the free market and Britain's role in the world. Until a generation or so ago, the language of 'left' and 'right' was not a feature of American politics. As I see it, the term 'left' still has some meaning if one identifies it with socialism and collectivist solutions, but that is not the orientation of modern social democratic parties. I believe the term 'right' has no meaning at all beyond right-wing populism.

To be sure, labels can be useful; we all use them all the time by way of shorthand and to capture the essence of some thing or idea. The problem arises when they lose their meanings, hinder rather than help communication, or just become pejorative terms that cloud debate. When that happens, as with the 'right-wing' label today and increasingly the 'left-wing' one as well, we would do better to shed them as useless abstractions. Instead of being stars to steer by, they become black holes.

Perhaps that view is gaining some currency. Last year I was delighted to receive a letter from the *Evening Post* saying a memo had been sent to all editorial staff "on the folly of using obsolete terms such as 'left' and 'right' wing". If that practice were followed more widely, and people were forced to report and listen to what others are actually saying, we might get more sense and substance into our social and economic debates.

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8 Albert Dicey, *Lectures on the Relation between Law and Public Opinion in England during the Nineteenth Century*, MacMillan, London, 1905.

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